

# *Protecting Investors: A Half Century of Investment Company Regulation*



**Division of Investment Management  
United States Securities and Exchange Commission**

**May 1992**

This is a report of the Division of Investment Management. The Commission has expressed no view regarding the analysis, findings, or conclusions herein.



**Division of Investment Management**  
United States Securities and Exchange Commission  
450 Fifth St. N.W., Washington, D.C. 20549



THE CHAIRMAN

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

May 1, 1992

When the Investment Company Act came into effect just over a half century ago, only **436** entities holding slightly more than \$2 billion in assets were covered by the new law. At the outset, there were fewer than **300,000** accounts in the newly registered "investment companies".

During the intervening years, investment companies have grown enormously in number, size and variety. Today, more than **3,500** investment companies in the United States hold over **\$15 trillion** in assets on behalf of over **68** million accounts. To put that in perspective, the assets of these investment companies are approximately 50% greater than the total value of *all* the stocks traded in London, one of the world's largest capital markets.

Without government subsidies or taxpayer credit, investment companies have operated with remarkable safety and provided capital to meet the needs of a growing economy. The most common type of investment company, the open end "mutual fund," has become the vehicle for professional management of the current investments and retirement savings of millions of Americans.

The Investment Company Act provides investors with specific protections against self-dealing, conflicts of interest, misappropriation of funds, and overreaching with respect to fees, expenses and undisclosed **risks** of many types. The SEC has the important **job** of policing these and other requirements of the law.

While regulation to protect investors is vital to public confidence, overly broad regulation can limit the choices of investors, and unnecessary regulatory costs are ultimately passed through to investors. Therefore, two years ago I asked the Division of Investment Management to conduct a thorough study of our system. In particular, I asked them to look at areas where the law should be more flexible, or where regulatory costs could be reduced, without sacrificing the quality of investor protection. After a half century of market change, it is appropriate to consider where we can update and improve the overall system.

The resulting report recommends a number of proposals for constructive evolution in this vital law. My fellow Commissioners and I look forward to reviewing these recommendations carefully. It is my hope that they will enhance innovation and efficiency in the capital markets while maintaining the highest quality of investor protection and market integrity.

A handwritten signature in black ink, appearing to read "Richard C. Breeden".

Richard C. Breeden



DIVISION OF  
INVESTMENT MANAGEMENT

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

May 1, 1992

Dear Mr. Chairman:

I am pleased to submit the Division of Investment Management's report on investment company regulation. Two years ago, with the approach of the fiftieth anniversary of the Investment Company Act of 1940, you asked the Division to take a fresh look at the regulation of investment companies to determine whether existing regulation imposed unnecessary constraints on investment companies or the provision of other financial services and whether there were gaps in investor protection.

The Division has devoted considerable effort to the report. In addition to a full-time staff of ten, virtually everyone in the Division has contributed. I especially would like to note the indispensable contribution of Matthew A. Chambers, whose leadership has guided the review from its inception. Special commendation also should go to Nancy Moms, who served as the deputy director of the project until late last year, and to Karen Skidmore and Diane Blizzard, whose office largely has been responsible for completing the work. We received substantial assistance from other Commission divisions and offices and from Mary Ann Gadziala, Counsel to the Chairman.

Without preconceived notions, we have sought the opinions of investor groups, academic researchers, the private bar, and the investment company, investment advisory, banking, pension, insurance, and brokerage industries. We have consulted with other government offices. We received and analyzed over two hundred comments and investigated the operations and dimensions of the financial markets. Research into the Act's history complemented our fact-finding efforts.

We have concluded that the regulatory system crafted half a century ago has worn well, providing the framework for the development of a dynamic industry. In some respects, however, regulation has not kept pace with the changes in financial markets and may prevent investment companies from offering flexible, efficient, and competitive vehicles for investing in the financial markets. It also may distort the activities of companies that should not fall within the Act.

We do not recommend changes to the fundamental protections that have worked so well since 1940. At the same time, we do recommend changes that we believe will promote investor protection, encourage innovation and flexibility, and facilitate competition and capital formation by removing unnecessary regulation. We believe that these changes should allow the financial markets to continue to provide United States investors with a broad range of sound and flexible investment options.

Sincerely,

*Marianne K. Smythe*  
Marianne K. Smythe  
Director

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## **ACKNOWLEDGMENTS**

In the preparation of this report, the Division had the able assistance of many members of the Commission staff. The Division Director at the inception of the study was Kathryn B. McGrath. The Division's original study team consisted of Matthew A. Chambers, Associate Director, Nancy Morris, Deputy Chief Counsel, Karen L. Skidmore, Assistant Director, Paul Goldman, Chief Financial Analyst, Diane C. Blizzard, Deputy Chief of Office, Wendell Faria, Deputy Chief of Office, Regina Hamilton, Branch Chief, Ann Glickman, Special Counsel, Rochelle Kauffman, Senior Counsel, Stuart Horwich, Attorney, Maura Murphy, Attorney, and Muriel Edwards, Secretary.

Many other members of the Division contributed to the drafting or editing of various sections, including Thomas S. Harman, Associate Director (Chief Counsel), Clifford Kirsch, Assistant Director, Robert Plaze, Assistant Director, Heidi Stam, Associate Chief Counsel, Kenneth J. Berman, Deputy Chief of Office, Angela Goelzer, Special Counsel to the Director, L. Bryce Stovell, Senior Special Counsel, Robert G. Bagnall, Special Counsel, Thomas Sheehan, Special Counsel, Lawrence Stoller, Special Counsel, Eva Carney, Senior Counsel, Roseanne Harford, Attorney, Richard Jackson, Attorney, Elizabeth Krentzman, Attorney, L. Hope Lewis, Attorney, Edward Rubenstein, Attorney, Gregory Jaffray, Compliance Examiner, Evelyn Malone, Legal Technician, and Michele Bartley, Secretary.

Many members of the Division also made significant contributions in reviewing and commenting on the report, including Gene A. Gohlke, Associate Director, Mary S. Podesta, Associate Director, Carolyn Lewis, Assistant Director, R. Michael Parker, Assistant Director, Jeremy N. Rubenstein, Assistant Director, Douglas Scheidt, Assistant Director, Sid Cimmet, Senior Special Counsel, Lawrence A. Friend, Chief Accountant, Stanley B. Judd, Senior Special Counsel, Michael Wible, Special Counsel, Yvonne Hunold, Senior Counsel, Thomas E. Bisset, Attorney, Marc Duffy, Attorney, Wendy Friedlander, Attorney, Patrice Pitts, Attorney, Nicholas Thomas, Attorney, Courtney Thornton, Attorney, Julia Ulstrup, Attorney, and Barbara Whisler, Attorney.

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# TABLE OF CONTENTS

J

## PROTECTING INVESTORS: A HALF CENTURY OF INVESTMENT COMPANY REGULATION

EXECUTIVE SUMMARY .....	<i>xvii</i>
-------------------------	-------------

### PART I. THE SCOPE OF THE INVESTMENT COMPANY ACT

Chapter 1. The Treatment of Structured Finance under the Investment Company Act .....	1
Chapter 2. Private Investment Company Exceptions .....	103
Chapter 3. Pooled Investment Vehicles for Employee Benefit Plan Assets .....	119

### PART II. REMOVING BARRIERS TO CROSS-BORDER SALES OF INVESTMENT MANAGEMENT SERVICES

Chapter 4. Internationalization and Investment Companies .....	185
Chapter 5. The Reach of the Investment Advisers Act of 1940 .....	221
Chapter 6. Performance Based Advisory Compensation .....	237

### PART III. REGULATION OF INVESTMENT COMPANIES

Chapter 7. Investment Company Governance .....	251
Chapter 8. The Sale of Open-End Investment Company Shares .....	291
Chapter 9. Investment Company Advertising .....	347
Chapter 10. Variable Insurance .....	373
Chapter 11. Repurchases and Redemptions of Investment Company Shares .....	421
Chapter 12. Affiliated Transactions .....	473
Chapter 13. Procedures for Exemptive Orders .....	503

---

## CHAPTER 1

### THE TREATMENT OF STRUCTURED FINANCE UNDER THE INVESTMENT COMPANY ACT

I.	INTRODUCTION AND SUMMARY OF RECOMMENDATIONS .....	1
II.	OVERVIEW OF STRUCTURED FINANCE .....	5
	A. The Structured Finance Market .....	5
	B. Sponsors of Structured Financings .....	15
	C. Purchasers of Structured Financings .....	20
	D. Expectations for the Future .....	24
III.	THE SECURITIZATION PROCESS .....	25
	A. The Components of a Structured Financing .....	26
	B. The Role of the Rating Agencies .....	49
	C. Unrated Transactions .....	63
IV.	THE INVESTMENT COMPANY ACT AND STRUCTURED FINANCE .....	66
	A. Applicability of the Act .....	66
	B. Effects of the Regulatory Structure .....	76
V.	THE REFORM OF THE TREATMENT OF STRUCTURED FINANCE .....	76
	A. The Potential for Abuse in Structured Financings .....	77
	B. The Lack of Abuse in Structured Financings .....	81
	C. Recommendation —An Exemptive Rule .....	83
	D. Other Options Considered .....	95
	E. Section 3(c)(5) .....	98
VI.	CONCLUSION .....	101

## CHAPTER 2

### PRIVATE INVESTMENT COMPANY EXCEPTIONS

I.	INTRODUCTION AND SUMMARY .....	103
II.	THE PRIVATE INVESTMENT COMPANY EXCEPTION .....	105
III.	A QUALIFIED PURCHASER EXCEPTION .....	110
IV.	OTHER OPTIONS CONSIDERED .....	114

---

V. CONCLUSION .....	116
Appendix2-A .....	<u>117</u>
CHAPTER 3	
<b>POOLED INVESTMENT VEHICLES FOR EMPLOYEE BENEFIT PLAN ASSETS</b>	
I. INTRODUCTION AND SUMMARY OF RECOMMENDATIONS .....	119
II. TREATMENT OF POOLED INVESTMENT VEHICLES UNDER THE FEDERAL SECURITIES LAWS .....	123
A. Historical Treatment of Bank Collective Trust Funds .....	123
B. Historical Treatment of Insurance Company Separate Accounts .....	128
C. Current Securities Laws Exemptions for Pooled Investment Vehicles .....	131
III. RECENT DEVELOPMENTS IN THE EMPLOYEE BENEFIT PLAN INDUSTRY .....	136
A. Increase in Number of Defined Contribution Plans .....	136
B. Growth of 401(k) Plans .....	139
C. Growth in Defined Contribution Plan Assets .....	140
D. Competition Among Mutual Funds, Banks, and Insurance Companies .....	143
IV. INFORMATION PROVIDED TO INVESTORS .....	144
A. Comparison of Disclosure and Reporting Requirements .....	145
B. Recommendations for Reform .....	151
V. SUBSTANTIVE REGULATION OF POOLED INVESTMENT VEHICLES .....	153
A. Fiduciary Standards .....	153
B. Prohibitions Against Self-Dealing: Investment Company Act, ERISA, and Regulation 9 .....	157
C. Fund Management .....	173
D. Valuation and Redemption .....	175
E. Advertising .....	176
F. Diversification .....	177
G. Liquidity .....	178
VI. CONCLUSION .....	178
Appendix3-A .....	182

---

## CHAPTER 4

### **INTERNATIONALIZATION AND INVESTMENT COMPANIES**

I.	INTRODUCTION AND SUMMARY OF RECOMMENDATIONS .....	185
II.	BACKGROUND — COMMISSION EXPERIENCE WITH SECTION 7(d) .....	191
	A. Early Canadian Applications and Rule 7d-1 .....	192
	B. Foreign Portfolio Sales Corporation Act of 1973 .....	193
	C. The 1975 Guidelines .....	194
	D. The Union-Investment Application .....	195
	E. The "Mirror Funds" Release .....	196
	F. The Foreign Investment Company Amendments Act of 1984 .....	198
	G. Section 7(d) and Private Offerings .....	200
III.	DISCUSSION — REMOVING UNNECESSARY BARRIERS TO CROSS-BORDER SALES .....	202
	A. Harmonization .....	202
	B. Treaties .....	204
	C. Recommendation — Amendment of Section 7(d) .....	205
IV.	OTHER IMPEDIMENTS TO CROSS-BORDER SALES .....	214
	A. United States Tax Law .....	215
	B. State "Blue Sky" Laws .....	216
V.	CONCLUSION .....	217
	Appendix 4-A .....	218

## CHAPTER 5

### **THE REACH OF THE INVESTMENT ADVISERS ACT OF 1940**

I.	INTRODUCTION AND SUMMARY OF RECOMMENDATIONS .....	221
II.	THE REACH OF THE INVESTMENT ADVISERS ACT — THE CURRENT APPROACH .....	223
III.	A CONDUCT AND EFFECTS APPLICATION OF THE INVESTMENT ADVISERS ACT .....	227
	A. The Statute's Jurisdictional Reach .....	227
	B. Policy Considerations Favoring a New Approach .....	228
	C. Access to Books and Records and Personnel .....	230

---

D. Implications of a New Approach .....	230
E. Other Alternatives .....	234
IV. CONCLUSION .....	236

## CHAPTER 6

### PERFORMANCE BASED ADVISORY COMPENSATION

I. INTRODUCTION AND SUMMARY OF RECOMMENDATIONS .....	237
II. AN OVERVIEW OF THE PERFORMANCE FEE PROHIBITION .....	241
III. DISCUSSION .....	245
A. Financially Sophisticated Clients .....	246
B. Foreign Clients .....	246
IV. RECOMMENDATIONS .....	247
Appendix6-A .....	250

## CHAPTER 7

### INVESTMENT COMPANY GOVERNANCE

I. INTRODUCTION AND SUMMARY OF RECOMMENDATIONS .....	251
II. CONFLICTS OF INTEREST AND INVESTMENT COMPANY GOVERNANCE UNDER THE ACT .....	255
A. The Role of the Board of Directors .....	255
B. The Role of Shareholders .....	260
III. THE DEBATE OVER THE CURRENT GOVERNANCE SYSTEM AND RECOMMENDATIONS FOR REFORM .....	263
A. The Debate over the Appropriate Role for Directors .....	264
B. Recommended Reforms of the Role of Directors .....	266
C. The Debate over Investment Company Shareholder Voting .....	272
D. Recommended Reforms of Investment Company Shareholder Voting .....	274
IV. ALTERNATIVE GOVERNANCE ARRANGEMENTS .....	282
A. The Original Unitary Investment Fund Proposal .....	283
B. Investor Protection Issues .....	284

---

C. Cost Considerations .....	286
D. The Impact of the UIF on Internationalization .....	287
E. Recommendations Concerning the UIF .....	288
V. CONCLUSION .....	289

## CHAPTER 8

### THE SALE OF OPEN-END INVESTMENT COMPANY SHARES

I. INTRODUCTION AND SUMMARY OF RECOMMENDATIONS .....	291
II. SALES LOADS AND RETAIL PRICE MAINTENANCE .....	298
A. The Purposes of Section 22(d) .....	299
B. Commission Action under Section 22(d) .....	303
C. Amendment of Section 22(d) to End Mandatory Retail Price Maintenance .....	307
D. Other Options Considered .....	314
III. SPONSORS OPTIONS FOR DISTRIBUTION FINANCING .....	315
A. The Treatment of Fees and Distribution Charges under the Act .....	315
B. Administrative Action Since 1940 .....	320
C. Proposed NASD Regulation of Rule 12b-1 Fees .....	325
D. Limited Amendments to Rule 12b-1 .....	326
E. Adoption of Rule 6c-10 .....	328
F. Multiple Class Exemptive Rule .....	330
IV. THE UNIFIED FEE INVESTMENT COMPANY AN ALTERNATIVE .....	332
A. Rationale for the Unified Fee Investment Company .....	334
B. Operation of a Unified Fee Investment Company .....	338
C. Investor Protection Issues .....	344
V. CONCLUSION .....	345
Appendix 8-A .....	346

## CHAPTER 9

### INVESTMENT COMPANY ADVERTISING

I. INTRODUCTION AND SUMMARY OF RECOMMENDATIONS .....	347
--	-----

---

II.	BACKGROUND .....	352
A.	Application of the Securities Act and Rules to Investment Company Advertising .....	352
B.	The Interplay of Rules 482 and 134 .....	360
III.	RECOMMENDATIONS .....	361
A.	"Investment Company Advertising Prospectuses" .....	361
B.	"Off-the-Page" Advertisements .....	363
IV.	OTHER OPTIONS CONSIDERED .....	369
A.	Requiring Prior Delivery of Mutual Fund Prospectuses .....	369
B.	Eliminating Liability under Section 12(2) .....	369
V.	CONCLUSION .....	370
	Appendix 9-A .....	371

## CHAPTER 10

### VARIABLE INSURANCE

I.	INTRODUCTION AND SUMMARY .....	373
II.	VARIABLE INSURANCE PRODUCTS UNDER THE FEDERAL SECURITIES LAWS .....	378
A.	Variable Annuities .....	378
B.	Variable Life Insurance .....	379
C.	The Introduction of Variable Products .....	380
D.	Periodic Payment Plans .....	382
E.	Application of Sections 26 and 27 to Variable Insurance Products .....	384
III.	PROBLEMS WITH THE CURRENT REGULATORY FRAMEWORK .....	390
A.	The Nature of the Products and Sponsors .....	390
B.	The Investment Charge -Insurance Charge Dilemma .....	394
C.	Problems With Variable Life Insurance -Industry Concerns .....	395
D.	Problems with Variable Annuities -- How Much Is the "Insurance" Worth? .....	400
IV.	RECOMMENDATION .....	402
A.	Statutory Amendments .....	403
B.	Disclosure Proposals .....	408
C.	Effects .....	410

---

V. CONCLUSION .....	417
Appendix 10-A .....	418

## CHAPTER 11

### REPURCHASES AND REDEMPTIONS OF INVESTMENT COMPANY SHARES

I. INTRODUCTION AND SUMMARY OF RECOMMENDATIONS .....	421
II. BACKGROUND .....	425
A. The Treatment of Open-End and Closed-End Investment Companies Under the Act: The Historical Context .....	425
B. The Re-Emergence of Closed-End Companies and the Problem of Discounts .....	432
C. Methods For Reducing Discounts .....	436
D. Closed-End Tender Offers .....	439
III. RECOMMENDATIONS .....	442
A. Repurchase Offers by Closed-End Companies .....	442
B. Limited Redemption Investment Companies .....	456
C. Portfolio Liquidity .....	463
D. Definition of Redeemable Security .....	466
IV. CONCLUSION .....	470
Appendix 11-A .....	471

## CHAPTER 12

### AFFILIATED TRANSACTIONS

I. INTRODUCTION AND SUMMARY OF RECOMMENDATIONS .....	473
II. CURRENT REGULATION OF AFFILIATED TRANSACTIONS UNDER THE INVESTMENT COMPANY ACT .....	474
A. Investment Companies .....	475
B. Business Development Companies .....	481
III. OPTIONS FOR REFORM AND RECOMMENDATIONS .....	482
A. Section 17(a) and Riskless Principal Transactions .....	485
B. Section 17(d) .....	488

---

C. Section 10(f) and Rule 10f-3 .....	499
IV. CONCLUSION .....	500
CHAPTER 13	
PROCEDURES FOR EXEMPTIVE ORDERS	
I. INTRODUCTION AND SUMMARY OF RECOMMENDATIONS .....	503
II. BACKGROUND .....	506
A. The Historical Use of Section 6(c) .....	506
B. Current Procedures for Obtaining Exemptive Relief under Section 6(c) .....	508
III. RECOMMENDATIONS TO EXPEDITE REVIEW OF EXEMPTIVE APPLICATIONS .....	509
A. Expedited Procedures for Applications Based on Precedent ..	510
B. Amendments to the Division's Delegated Authority .....	514
IV. OTHER OPTIONS CONSIDERED .....	515
A. Automatic Effectiveness for All Applications Absent Commission Action .....	515
B. Dispensing with Prior Notice for Routine Applications .....	518
C. Substantive Changes to Section 6(c) .....	518
D. Increased Use of Rulemaking Authority .....	521
V. CONCLUSION .....	522
Appendix 13-A .....	523

---

# FIGURES AND TABLES

Figure ES-1 Growth of Management Investment Company Assets <b>1940-1990</b> .....	<i>xix</i>
Figure <b>1-1</b> Comparative Data Reflecting Growth of Structured Finance in the United States <b>1986-1991</b> .....	<b>3</b>
Figure <b>1-2</b> Mortgage-Backed Securities Issued in the United States <b>1986-1991</b> .....	<b>6</b>
Figure <b>1-3</b> Non-Mortgage Asset-Backed Securities Issued in the United States <b>1986-1991</b> .....	<b>12</b>
Figure <b>1-4</b> Total Issuance of Non-Mortgage Asset-Backed Securities by Collateral Type .....	<b>14</b>
Figure <b>1-5</b> Structured Financing Components .....	<b>26</b>
Figure <b>1-6</b> Financing Backed by Credit Card Accounts Receivable .....	<b>42</b>
Figure <b>1-7</b> A Master Trust Structure .....	<b>47</b>
Figure <b>3-1</b> Total Number of Pension Plans in <b>1988</b> .....	<b>137</b>
Figure <b>3-2</b> Growing of Defined Contribution Plans .....	<b>138</b>
Figure <b>3-3</b> Pension Plan Assets by Type of Plan <b>1975-88</b> .....	<b>141</b>
Figure <b>3-4</b> Comparison of Pension Plan Assets <b>1981 vs. 1988</b> .....	<b>142</b>
Figure <b>3-5</b> <b>1988</b> Pension Plan Assets -- Small Plans .....	<b>143</b>
Table <b>3-1</b> Total Pensions Plan Assets (billions) in Pooled Vehicles, <b>1990</b> .....	<b>144</b>
Table <b>3-2</b> Summary of Status Quo and Recommendations .....	<b>180</b>
Figure <b>10-1</b> Estimate of Annualized New Premium Market Share by Product .....	<b>376</b>
Figure <b>11-1</b> Premiums and Discounts from NAV for IPOs of Closed-End Funds .....	<b>435</b>
Figure <b>12-1</b> Upstream Affiliations .....	<b>476</b>

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## EXECUTIVE SUMMARY

In the half century since the enactment of the Investment Company Act of 1940, tremendous growth and structural change have taken place in the financial markets, including the investment company industry. In light of this growth and change, the Chairman of the Securities and Exchange Commission established a task force composed of members of the Division of Investment Management to reexamine the manner in which investment companies and other pooled securities vehicles are regulated.

The modern investment company industry had its genesis in the 1920's when legal impediments to one corporation holding the stock of another had fallen. As businesses prospered and common stocks reached record highs, investors of modest means sought to participate in the stock market. Established brokers, investment bankers, and other members of the financial community began actively to promote the investment company concept and to distribute investment company securities.

While the concept itself -- the pooling of funds to provide for diversification, economies of scale, and professional management -- had and still has obvious merit, the early rapid growth of the industry came, in large measure, at the expense of the investing public. Frequently, investment company assets were used by unscrupulous sponsors to further their own business interests. Failures to observe principles of fiduciary duty were widespread, and, as a consequence, holders of investment company securities, including the small, unsophisticated investors for whom the investment company product was so attractive, lost large sums of money.

By the mid-1930's, the problems of the unregulated investment company industry were such that Congress recognized the need to take action. In 1935, Congress directed the Commission to study the fledgling investment company industry and report its findings. Between 1938 and 1940, the Commission transmitted to Congress an exhaustive report on the investment company industry. The report, commonly known as the "Investment Trust Study," laid the foundation for the Investment Company Act. Following several preliminary bills, the legislation that was finally enacted in 1940 was the product of cooperative negotiations between representatives of the Commission and of the investment company industry.

The Investment Company Act reflects a congressional recognition that substantive protections beyond the disclosure requirements of the Securities Act of 1933 and the Securities Exchange Act of 1934 were needed because of the unique character of investment companies and their role in channeling savings into the national economy. As Congress observed in section 1 of the Investment Company Act, "[investment] companies are media for the investment in the

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national economy of a substantial part of the national savings and may have a vital effect upon the flow of such savings into the capital markets . . . ."

The Investment Company Act establishes a comprehensive federal regulatory framework for investment companies. Regulation of investment companies is designed to:

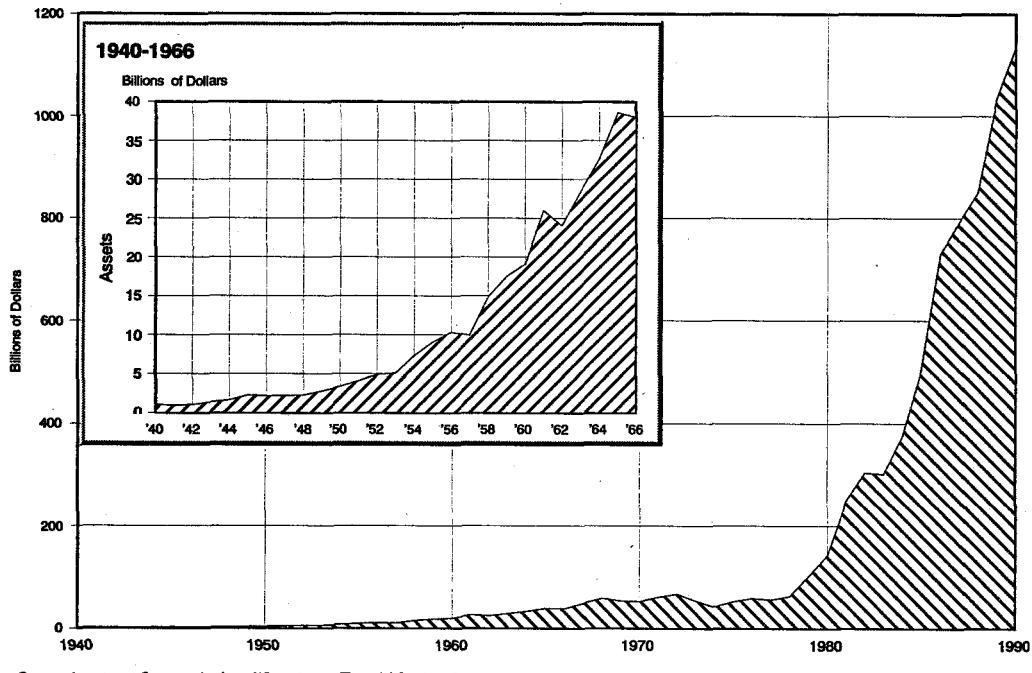
- prevent insiders from managing the companies to their benefit and to the detriment of public investors;
- prevent the issuance of securities having inequitable or discriminatory provisions;
- prevent the management of investment companies by irresponsible persons;
- prevent the use of unsound or misleading methods of computing earnings and asset value;
- prevent changes in the character of investment companies without the consent of investors;
- prevent investment companies from engaging in excessive leveraging; and, finally,
- ensure the disclosure of full and accurate information about the companies and their sponsors.

To accomplish these ends, the Investment Company Act requires the safekeeping and proper valuation of fund assets, restricts greatly transactions with affiliates, limits leveraging, and imposes governance requirements as a check on fund management.

Since 1940 and particularly in the last decade, the investment company industry has grown rapidly. In 1940, the industry held only about two billion dollars in assets, including 105 registered *management* investment companies holding slightly more than one billion dollars in assets. Today, the industry serves as one of the nation's largest financial intermediaries, with more than 3,500 investment companies, and holding over \$1.3 trillion in assets as of the end of 1991. Approximately twenty-five percent of American households invest in investment companies -- either directly, or indirectly through pension funds and similar vehicles.

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**FIGUREES-1**  
**Growth of Management Investment Company Assets 1940- 1990**



As the industry has grown, its composition also has changed greatly. In **1940**, the dominant form of management investment company was the closed-end company. Open-end companies had only recently been popularized and had assets whose value was approximately only two-thirds of the value of closed-end companies. Unit investment trusts also were very popular.

In contrast, by **1966**, the open-end segment had grown dramatically and accounted **for** eighty-two percent of industry assets. Today the investment company industry continues to be dominated by the open-end companies, or mutual funds, as they are more commonly known. Such funds currently account for ninety-five percent of industry assets. A particular form of open-end company, the money market fund, which did not exist until the late 1970's, now accounts for forty-one percent of the industry's assets.

Increasingly, mutual funds are organized in investment company "complexes," *i.e.*, large groups of mutual funds associated with common advisers or underwriters, typically with liberal exchange privileges among the funds. The one hundred largest mutual fund complexes account for eighty-five percent of total investment company assets.

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In spite of this dramatic growth and the concomitant changes in the character of the industry, the Investment Company Act has been amended significantly only once, in 1970. That legislation followed two studies of investment company operations: the Wharton School of Finance's "A Study of Mutual Funds," published in 1962, and the Commission's "Report on the Public Policy Implications of Investment Company Growth," published in 1966. The 1970 amendments added a number of new provisions to provide additional safeguards and protections for public investors. Most significantly, the amendments enhanced the effectiveness of boards of directors as checks on management by strengthening the independence of boards and increasing their role. In addition, the amendments added new provisions restricting sales charges and fund expenses.

In recent years, continued industry growth has been fueled in large part by dramatic changes in the financial marketplace. Institutional demand for collective investment products accounts for a significant portion of that growth. When the Investment Company Act was passed, few, if any, institutional investors invested in investment companies. Institutional assets, which accounted for only eleven percent of investment company assets in 1970, now account for over twenty-five percent of total investment company assets.

In addition, in recent years, an international market for professional asset management has emerged. Investment companies have proved to be attractive vehicles for investors who wish to invest in diversified portfolios of foreign securities. Internationalization of the securities markets also has sparked interest in eliminating barriers to cross-border sales of investment company services.

Marketplace innovations also have led to a host of new pooled securities products that either were not anticipated or whose significance was not fully appreciated when the Investment Company Act was passed or in 1970. Many of these products are constrained by the framework of a statute that originally was designed to deal with only those limited forms of pooled investment vehicles that existed in the marketplace in the 1930's.

For example, a relatively new financial technique called structured finance or securitization is revolutionizing corporate finance, enabling companies to borrow at low cost while providing investors with high quality debt insulated from the credit risk of the company. This technique has gained widespread acceptance. In fact, structured finance volume now constitutes more than half of all United States corporate bond new issue volume. This technique was not anticipated when the Investment Company Act was enacted. Thus, some but not all structured financings fall within the Act's definition of investment company but, as a practical matter, those offerings that fall within the definition of investment company cannot operate as registered investment companies within the regulatory framework of the Act as currently written.

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Another example of an unanticipated development is the emergence of defined contribution retirement plans. These plans give individuals a far greater say and responsibility in the investment of their retirement savings than do defined benefit plans and are changing the way in which millions of Americans provide for post-retirement benefits. Increasingly, retirement plans are funded with employees' own contributions and employees choose among a number of funding vehicles, including registered investment companies, bank collective funds, and insurance separate accounts. The employees, of course, bear the risk of their choices. Today, almost forty percent of all private pension plan assets are held in defined contribution plans, and present trends suggest that this number will increase substantially by the end of the century.

To compete more effectively with other financial intermediaries, insurance companies have developed variable insurance contracts. These contracts, hybrids of insurance and investment, were not contemplated by the original drafters of the Investment Company Act, nor were they in widespread use in 1970. Consequently, treatment of variable insurance contracts under the Investment Company Act presents a number of regulatory and practical problems.

To evaluate the need for modernization of the regulation of pooled investment vehicles, the Division identified a number of significant issues that appeared to merit reexamination. The Commission published a concept release, Investment Company Act Release No. 17534 (June 15, 1990), to seek public comment on these issues and any other issues commenters believed significant. In response, the Commission received over 200 comment letters, many of which provided detailed analyses of significant regulatory issues and suggested specific regulatory or legislative solutions. In addition, the Division met with representatives of numerous groups, including investor groups, mutual fund sponsors, mutual fund directors, securities dealers, banks, insurance companies, rating agencies, trade associations, and state, federal, and foreign regulators. Finally, the Division reexamined the historical basis for the current regulatory approach, including legislative and administrative history and prior Commission studies.

The many technological and innovative changes in financial markets since 1940 and even since 1970 have compelled this review of the Investment Company Act and are reflected in the conclusions and recommendations of this report. The recommendations are aimed at achieving three critical objectives:

- maintaining and improving the current level of investor protection;
- facilitating competition and capital formation by removing barriers; and

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- encouraging innovation.

Our recommendations leave unchanged the fundamental principles underlying the Investment Company Act. Their soundness is demonstrated by the successful and safe operation of investment companies. Indeed, those principles are partially responsible for the remarkable success of the industry. Of course, no amount of regulation can prevent unsuccessful management of investment companies or losses on investments. It can, however, limit self-dealing, undue risks, and imprudent practices, as well as promote informed investor choice.

The Division's reexamination of the Investment Company Act in light of the financial markets of the 1990's addressed a number of specific topics, which fall into three broad categories:

- The appropriate scope of the Act; that is, its applicability to various pooled investment vehicles that may fall within the definition of investment company or may resemble traditional investment companies.
- How best to remove unnecessary barriers to cross-border sales of investment management services.
- The regulation of investment company operations under the Act and the other federal securities laws.

Our key recommendations are discussed below.

## **The Scope of the Investment Company Act**

**The Treatment of Structured Finance under the Investment Company Act** In the last decade, the structured finance industry has become a major facet of American financial markets. Since its origination in the 1970's with the securitization of residential mortgages, modern structured finance has evolved to include securities backed by credit card receivables, automobile loans, corporate bonds, and other financial assets.

Under current law, structured financings literally fall within the Investment Company Act's definition of investment company because they both hold and issue securities. As a practical matter, structured financings cannot register as investment companies because they cannot operate under the Act's provisions. Some structured financings have not been regulated under the Act based on statutory exceptions that were intended for very different businesses. Other financings, primarily involving mortgage products, have received exemptions by Commission order. Financings that are unable to rely on an exception or obtain an exemptive

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order are sold offshore or in private placements to not more than one hundred investors. Thus, today the Act distorts the operation and growth of the structured finance market by enforcing distinctions that do not reflect economic reality.

In light of these distinctions between structured financings and traditional investment companies and the virtually abuse-free record of structured financings, the Division recommends that:

The Commission should adopt a rule exempting structured financings from the Investment Company Act, subject to requirements that would address the potential investor protection concerns presented by structured financings. The requirements -- essentially those imposed today by the marketplace -- should restrict the degree of "management" of exempt financings, prohibit the issuance of redeemable securities, require ratings in the top two investment grades for all publicly-issued securities, and mandate independent trustees.

The adoption of the rule is intended to remove the artificial constraints that the Act now imposes on the market, while addressing investor protection concerns that may be raised by structured finance offerings.

Private Investment Company Exceptions. The Investment Company Act excepts from the definition of "investment company" any issuer whose securities are owned by not more than 100 persons and that is not making and does not presently propose to make a public offering. This "private investment company" exception is used by a wide variety of issuers, including small groups of ordinary investors such as investment clubs and pools of Sophisticated institutional investors. For investment companies whose shares are held by less sophisticated investors, the 100 investor limit reasonably reflects the point at which federal regulatory concerns are raised. For funds that sell exclusively to sophisticated investors, however, the 100 investor limit is an unnecessary constraint not supported by sufficient public policy concerns. In light of these factors, the Division recommends that:

The Investment Company Act should be amended to add a new exception for investment companies whose securities are owned exclusively by such "qualified purchasers" as designated in Commission rulemaking.

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**Section 3(c)(1) should be amended to simplify the existing shareholder attribution provision to facilitate investments in the excepted issuers.**

**The Act should be amended to make both private investment companies and the new qualified purchaser pools subject to the restrictions in section 12(d)(1) governing purchases of securities of registered investment companies.**

The pyramiding restrictions in section 12(d)(1) thus would apply to all issuers relying on the new "qualified purchaser" exception and all issuers relying on section 3(c)(1), but only with respect to investments in registered investment companies. Investments in the proposed qualified purchaser pools and section 3(c)(1) companies by registered investment companies would not be limited under section 12(d)(1). While protecting the public shareholders of registered investment companies, the amendment would facilitate registered investment company participation in venture capital funds. In addition, the Division has concluded that the existing shareholder attribution provision in section 3(c)(1) is overly broad. By simplifying the provision, the amendment would ease compliance problems without lessening investor protection.

**Pooled Investment Vehicles for Employee Benefit Plan Assets.** Bank collective funds and insurance company separate accounts that hold assets of employee benefit plans are exempt from the registration requirements of the federal securities laws. Thus, these vehicles are not regulated as investment companies, even though they are similar functionally and structurally to investment companies; and they do not provide plan participants with disclosure comparable to that required under the securities laws. Historically, these exemptions were premised upon the following assumptions:

- that interests in these vehicles were offered not to the public, but to employers that are sophisticated investors and that can fend for themselves by obtaining adequate information and by negotiating with the vehicles' sponsors; and
- that retirement plans were predominantly defined benefit plans, under which the employer made the investment decisions and bore the financial risk of ensuring the fund had sufficient assets to meet pension obligations.

When the exemptions were enacted, those assumptions were essentially correct, but in the past twenty years retirement plans have changed materially. A substantial and fast-growing portion of retirement plans now consists of defined contribution plans. Under these plans, the employee

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often makes an investment decision about the vehicle in which the contributions allocated to the employee's account will be invested, and the employee bears the investment **risk** of the performance of the plan vehicles.

From a functional regulation perspective, it can be argued that mutual funds, bank collective funds, and insurance separate accounts sold to plan participants should be regulated under a common and uniform set of principles, and hence that bank collective funds and separate accounts should be regulated as management investment companies. Nevertheless, the costs of a major regulatory overhaul that would apply the Investment Company Act to these vehicles do not appear justified at this time. The Employee Retirement Income Security Act of 1974 imposes a number of obligations on those vehicles and generally provides investor protection in the same areas as the Investment Company Act, and we are unaware of any widespread abuses under the existing system that would be eliminated by applying the Act to these vehicles. Accordingly, the Division does not recommend that bank collective trust funds or insurance company separate accounts containing retirement plan assets be required to register under the Investment Company Act.

By contrast, these vehicles are not required to make significant disclosure to plan participants, yet participants who direct their own investments in defined contribution plans are in essentially the same position as any investor. For many Americans these pooled retirement vehicles are the most important investment in their lives. Those plan participants' investment decisions should have the benefits of the same disclosure obligations under the securities laws as other investment decisions. Accordingly, to ensure that plan participants receive full and fair disclosure, the Division recommends that:

**The Commission should propose amending the Securities Act of 1933 to remove the exemption from registration for interests in pooled funding vehicles for participant-directed defined contribution plans. The Commission also should propose amending the federal securities laws to require the delivery of prospectuses to plan participants who direct their investments.**

**The Commission should further propose amending the Securities Exchange Act of 1934 to require the delivery of semiannual and annual shareholder reports for the underlying investment vehicles (other than registered investment companies) to these plan participants.**

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The Commission should amend the rules under the Investment Company Act to require the delivery of semiannual and annual reports of underlying registered investment companies to these plan participants.

Such disclosure should help plan participants make more informed decisions about their retirement assets and promote greater competition among investment vehicles offered under defined contribution plans.

## **Removing Barriers to Cross-Border Sales of Investment Management Services**

Internationalization and Investment Companies. As a result of technological advances and the removal of many legal impediments to foreign participation, the world securities markets have become internationalized to an unprecedented degree in the last decade. Although investors worldwide appear more eager than ever to diversify their investments with managed portfolios of foreign securities, access by United States investors to foreign investment companies and by foreign investors to United States investment companies generally remains limited, in large part because of legal barriers to cross-border sales of investment company shares. In view of the opportunities for both United States investors and investment companies if hurdles to cross-border sales are lowered, the Division recommends that the Commission adopt a multifaceted approach to remove such barriers.

Section 7(d) of the Investment Company Act is a major hurdle. This section prevents a foreign investment company from making a public offering in the United States unless the Commission finds that it can enforce the company's compliance with all provisions of the Act. The enforceability standard in effect prohibits foreign investment companies from publicly offering their securities in the United States since it requires them virtually to transform themselves into United States investment companies. Because of these burdens, no foreign investment companies have registered since **1973**. Accordingly, the Division recommends that:

The Commission should propose amending section 7(d) of the Investment Company Act to permit foreign investment companies to sell shares in the United States if they can demonstrate that they are subject to regulation in their home country that provides substantially equivalent investor protection and that permitting their entrance into the United States markets would be in the public interest. To facilitate this process, the Commission should be authorized to enter into bilateral regulatory memoranda of

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understanding with the securities authorities in countries with regulatory regimes providing the same type and quality of investor protections as provided by the Investment Company Act.

The Commission generally should support tax law changes to enable United States investment companies securing access to foreign markets to compete effectively with foreign investment companies, and the Commission should continue to work with state regulators to eliminate duplicative substantive regulation of investment companies.

Implementing these recommendations should create a framework for regulatory cooperation and mutual recognition of investment company regulation, thus providing complementary access to investment company markets without sacrificing investor protection.

**The Reach of the Investment Advisers Act of 1940.** The scope of the Investment Advisers Act is critically important for the internationalization of investment management services. When an investment adviser, foreign or domestic, registers under the Advisers Act, the Division has taken the position that all of the adviser's advisory activities everywhere are subject to the Advisers Act. Many of the Advisers Act's requirements, however, are different from or exceed those that apply to foreign advisers in their home country and may be contrary to accepted business practices there. Consequently, a foreign adviser that registers under the Advisers Act because it does business in the United States, as well as in its home country, may find itself unable to engage in legal and acceptable business conduct in its home country because the Advisers Act prohibits it. To avoid the consequences of this position, some foreign advisers establish "independent" subsidiaries, registered in the United States, to advise their clients here. Those subsidiaries, however, are subject to strict requirements that may restrict their ability to function effectively and also may reduce the quality of investment advice they are able to provide to United States investors.

To alleviate these problems, the Division recommends that:

The Division should issue no-action letters narrowing the application of the Advisers Act to the activities of registered advisers with their foreign clients, in accordance with a "conduct" and "effects" approach. Under that approach, the Commission generally would not regulate a registered foreign adviser's dealings with clients outside the United States, but would regulate a registered domestic adviser's dealings with foreign

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clients where a sizable amount of advisory conduct occurs in the United States. To ensure the Commission's ability to police overseas conduct that affects United States clients, registered advisers would still be required to maintain records regarding their own overseas trading and that of their clients and provide the Commission with access to their overseas personnel.

This approach would be consistent with the Commission's other international initiatives under the other federal securities laws. The approach also would permit greater flexibility for foreign advisory businesses to form and register separate subsidiaries or affiliates here.

Performance Based Advisory Compensation. The Advisers Act generally prohibits a registered investment adviser from receiving compensation on the basis of a share of capital gains in, or capital appreciation of, a client's account. Subject to specific requirements, limited exemptions from that prohibition are available for advisory contracts with registered investment companies, business development companies, and certain clients with significant assets. By contrast, many foreign countries do not impose any restrictions on performance-based fees, and such fees are a customary way of doing business in those countries. United States registered advisers, however, are subject to the Advisers Act's limits on such fees, even when dealing with non-United States clients. Moreover, none of the current exemptions is sufficiently flexible to permit sophisticated clients not needing the protections of the prohibition to structure advisory fees on terms they determine are appropriate.

To provide more flexibility in the use of performance fees, the Division recommends that:

The Commission should propose amending the Advisers Act's limits on performance-based advisory fees to grant the Commission rule-making authority to exempt two types of advisory relationships from the restrictions on performance fees. First, United States registered advisers should be permitted to enter into performance fee contracts with non-United States clients to the extent that these compensation arrangements are lawful in the clients' home jurisdiction. Second, the performance fee restrictions should be amended to provide an exception for contracts with clients who the Commission determines by regulation, do not need the protections of the prohibition, based on factors such as wealth and financial sophistication.

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The first change would reduce the competitive burden on domestic advisers seeking to compete in overseas markets. The second change would give United States registered advisers and sophisticated institutional investors greater flexibility to structure appropriate compensation arrangements.

## **Regulation of Investment Companies**

Investment Company Governance. The Investment Company Act's requirements concerning the organizational structure of open-end investment companies, which interpose independent directors as a check on investment company sponsors, are fundamentally sound. They provide significant protections against the inherent conflicts between the interests of public investors and the interests of fund sponsors. At present, the Investment Company Act requires that a majority of the board be independent only in limited circumstances. To strengthen the independence of boards, the Division recommends that:

The Commission should propose amending the Investment Company Act to require that the minimum proportion of independent directors on investment company boards be increased from forty percent to a majority, and that independent director vacancies be filled by the remaining independent directors. Independent directors should be given the authority to terminate advisory contracts.

At the same time, a small number of provisions would be amended to eliminate requirements that independent directors make detailed, formalistic findings in areas that generally do not present the potential for conflict between the interests of a fund and its adviser. Specifically, the Division recommends that:

The Commission should amend rules under the Investment Company Act to streamline requirements for board review and approval of foreign custody arrangements, domestic securities depositories, and the time of day for determining net asset value.

These changes should increase directors' effectiveness by allowing them to focus on what they do best -- exercising business judgment in their review of interested party transactions and in their oversight of operational matters where the interests of a fund and its adviser may diverge.

While shareholder voting continues to be important as an effective means of communication, deterrence, and holding the board accountable, some

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of the voting requirements under the Investment Company Act do not comport with the realities of modern securities markets and do not really protect investors. Accordingly, the Division recommends that:

The Commission should propose amending the Investment Company Act to eliminate requirements that shareholders ratify the initial advisory contract, concur in the board's selection of fund auditors, or approve changes in relatively routine investment policies.

The Commission **also** should recommend amending the Investment Company Act to require that shareholders approve any change in a fund's investment objective in order to clarify that the investment objective is a critical determinant of the potential risk and reward inherent in the shareholder's investment.

The Commission should eliminate the requirement that shareholders ratify the initial rule 12b-1 plan (if **any**) of a newly organized fund, but should not recommend changes to voting requirements relating to amendments to rule 12b-1 plans that materially increase the amount spent on distribution.

The Investment Company Act relies on boards of directors to monitor investment company operations and resolve conflicts of interest; available data suggest that board operations impose minimal costs upon investment companies. Accordingly, the Division does not recommend changes that would permit the introduction of a unitary investment fund or other contractual structure that would eliminate shareholder and director voting. In view of the importance of director and shareholder voting requirements under the Investment Company Act, it would be fundamentally incompatible with the Act's regulatory philosophy to introduce such alternative structures, which would have little or no apparent benefits for investors.

**The Sale of Open-End Investment Company Shares.** Over the past fifty years, tremendous changes have taken place in how mutual funds sell their securities (known as "distribution") and in how the sales are regulated. Today, the major distribution issue facing the Commission continues to be the degree and effect of competition in the mutual fund industry. We conclude that fund pricing is not as market-driven as it could be. Accordingly, the Division's recommendations focus on eliminating regulatory impediments to vigorous price competition, increasing investor understanding of total investment costs, promoting cost comparability among funds, and easing restrictions so that funds may experiment with distribution arrangements that make costs more explicit. We believe these

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changes would promote price competition and more economical and efficient distribution methods.

a. Retail Price Maintenance. Section 22(d) of the Investment Company Act requires that investment company sponsors fix the prices at which redeemable shares are sold to the public and that retail dealers adhere to those prices. Together with section 22(f), which permits mutual funds to impose restrictions on transferability of shares, this provision inhibits price competition in the distribution of mutual fund shares, harming investors by causing higher prices than might otherwise be available in a competitive marketplace. Accordingly, in order to promote greater competition in the distribution of mutual funds, the Division recommends that:

The Commission should propose amending section **22(d)** of the Investment Company Act to repeal the retail price maintenance requirement and to provide the Commission with explicit authority to issue orders or rules **to** deal with any issues of investor protection or the operation of the secondary market that may arise.

This proposal would promote retail competition among dealers and permit the market to develop more efficient methods of mutual fund distribution. In addition, this proposal could facilitate the creation of new and innovative products that depend on free secondary markets in their securities.

b. Investor Choice. Since 1980, Commission rules and exemptive orders have permitted the development of a variety of distribution financing methods in addition to the traditional front-end loads. These innovations have included asset-based sales charges, contingent deferred sales loads, and the offering of multiple classes in the same portfolio. In response to a number of issues arising out of the use of these methods, the Division recommends that a variety of distribution options currently permitted under individual exemptive orders also be codified and that certain outstanding rule proposals be adopted with appropriate modifications.

The Commission should adopt its outstanding rule proposal to permit deferred loads, including installment loads assessed directly on a shareholder's account. While tax consequences apparently would inhibit widespread use of installment loads, there is no reason to require individual exemptive orders for their use.

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The Commission should adopt only limited amendments **to** the rule governing asset-based sales loads, or rule 12b-1 fees, consistent with the continued use of spread loads and the proposal by the National Association of Securities Dealers, Inc. to regulate these loads under its maximum sales load rule.

The Commission should adopt a new exemptive rule to permit multiple class arrangements which can increase investor choice, result in economies of scale and certain efficiencies in the distribution of fund shares, and allow fund sponsors to tailor products more closely to the needs of investors.

In combination, these changes will allow funds to offer investors a variety of methods of financing distribution costs while enhancing investors' comprehension of their choices.

c. Unified Fee Investment Companies. The array of fees and loads available to investors does increase investor choice but also may impede price competition. The Division believes that price competition might be improved if, ironically, still *another* form of investment company were permitted -- one with a simplified fee structure and low barriers to exit by dissatisfied shareholders. Accordingly, the Division recommends that:

The Commission should propose amending the Investment Company Act to permit the introduction of a new investment vehicle -- a unified fee investment company ("UFIC"). The UFIC would have **a single, fixed fee**, set by the vehicle's "investment manager" and no sales charges or redemption fees. All UFIC expenses, except brokerage commissions on the fund's **own** portfolio transactions and extraordinary costs, would be paid from the fee or from the manager's own resources. Rule 12b-1 would not apply. The level of the fee would be prominently displayed on the cover page of the prospectus and in all sales literature and advertising. To protect investors should competition not restrain fee levels for the UFIC, the Act would prohibit "unconscionable or grossly excessive" unified fees. The fee would not require shareholder or director approval nor would it be subject to private litigation.

Because such funds would not impose either front-end or deferred sales loads, dissatisfied investors could "vote with their feet." A unified fee structure would substitute market competition for the oversight role of boards of directors and courts, who today review the fee levels of investment companies to prevent excessive charges to investors. The UFIC would have a board of directors to police operational conflicts and approve a variety of activities, just as do other funds. The board would oversee the

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level of services provided to the UFIC through review of all material contracts.

**Investment Company Advertising.** Under the Securities Act, investment companies historically have experienced unique problems communicating with the public. First, unlike traditional issuers which generally only offer their shares periodically, mutual funds and unit investment trusts continuously offer and sell their shares and units to the public, and, therefore, are continuously subject to the Securities Act's advertising requirements. In addition, because the Securities Act broadly defines the term "offer," and because the "products" of an investment company are its securities, virtually every written attempt by an investment company to promote and make the public aware **of** its products is potentially an offer to sell **its** securities that must conform to the Securities Act's advertising requirements. Traditional issuers, in contrast, whose products are not securities, do not have this problem and may advertise their products more freely. Finally, the advertising restrictions of the Securities Act restrict direct-marketed funds more than funds sold through brokers. Direct-marketed funds use print, radio, and television almost exclusively to sell fund shares, while broker-sold funds employ sales personnel who sell fund shares orally. Since the advertising restrictions of the Securities Act generally apply to written communications but not to oral communications, broker-sold funds have an advantage over direct-marketed funds. To promote more effective written communications with investors, the Division recommends that:

The Commission should propose amending the Securities Act to delete the requirement that all of the information in an investment company's "omitting prospectus" must be derived from the statutory prospectus and to add a provision for a new "advertising prospectus" for investment companies. The contents of the advertising prospectus would not be restricted to information "the substance of which" is contained in the statutory prospectus. In addition, the Commission should rescind the special provisions in the tombstone rule for investment companies.

The Commission should also adopt amendments to the Securities Act rules to permit mutual funds to sell "off-the-page" directly from advertisements, as is the practice in several European countries, without requiring that investors first receive a statutory prospectus. Off-the-page advertisements would be required **to** contain such information as the Commission may prescribe, such as fees and expenses, performance data, investment objectives,

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and risks. The advertisements would also be required to inform investors about the availability of a statutory prospectus, and the mutual fund would still be required to deliver a statutory prospectus to investors prior to, or with, the earlier of the confirmation of the sale or the delivery of the security. In addition, off-the-page advertisements would be section 10 prospectuses, and hence subject to section 12(2) prospectus liability.

These proposals should make it easier for investment companies to market their funds and for investors to receive useful information. In addition, the proposals would subject all investment company advertising to prospectus liability which, in turn, will maintain the high level of investor protection that exists today.

**Variable Insurance.** Variable annuities and variable life insurance contracts are regulated both as insurance products under state law, and as securities under the periodic payment plan model under sections 26 and 27 of the Investment Company Act, which imposes considerable limits on individual charges such as distribution costs and administrative fees. With variable insurance products, the policyholder's premium payments are allocated to a segregated or "separate" account investing in a portfolio of securities, not to the company's general account (which receives premiums for most life insurance and annuity policies). Under variable contracts, certain benefits (such as cash surrender values, annuity payments, and death benefits) reflect the investment performance of the portfolio of the applicable separate account. While variable insurance contracts are regulated as periodic payment plan certificates, they are not comparable investment products. The variable life contracts, in particular, have huge start-up and issuance costs, and multiple insurance and administrative costs that are not provided for adequately under current Investment Company Act regulation. In addition, because the contracts are hybrids of insurance and investment, with state insurance law applying to the insurance elements of the contracts and federal securities laws to the investment elements, difficult jurisdictional and practical problems arise, particularly over the regulation of contract charges. Accordingly, in order to recognize the unique nature of variable insurance contracts the Division recommends the following:

The Commission should recommend amending sections 26 and 27 of the Investment Company Act to exempt variable insurance contracts from certain charge limitations under those provisions and **to** improve flexibility of pricing by requiring aggregate contract charges simply to be reasonable in relation to the services rendered under the contracts, the expenses expected to be incurred, and the risks assumed by the insurance company. The

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amendment also should provide the Commission with rulemaking authority to establish standards of reasonableness if the market should fail to provide competitive prices or if abusive industry practices should develop.

Under the amendment, the Commission's role in regulating contract charges would be made more consistent with the unique features of variable insurance and the Commission's approach to regulating charges in the mutual fund industry.

**Repurchases and Redemptions of Investment Company Shares.** Traditionally, investment company regulation has maintained a relatively rigid separation between open-end and closed-end investment companies. Open-end companies must price their shares daily and pay redemption proceeds to investors within seven days of receipt of a redemption request. With limited exceptions, closed-end companies may not repurchase their shares directly from shareholders, except through cumbersome and expensive tender offers. Some investment companies today elect closed-end status because they invest in markets that, for various reasons, make it impractical to pay redemption proceeds within seven days. Many closed-end companies, however, tend to trade at a discount from their net asset value and thus are unattractive to many investors. Accordingly, to permit a greater range of options and innovation, the Division recommends that:

The Commission should adopt a new rule under section **23** of the Investment Company Act defining circumstances under which closed-end companies may conduct regular repurchases of their shares directly from shareholders at prices based on net asset value.

The Commission also should adopt a new exemptive rule under section **22** of the Investment Company Act permitting new variations on the open-end form, to be called "limited redemption" investment companies, offering alternative redemption and offering procedures to investors. Such companies would be either *extended payment companies*, which would redeem shares continuously but take longer to make payments than the seven days currently mandated for open-end companies, or *interval companies*, whose shareholders could redeem at fixed regular intervals, such as monthly. To prevent investor confusion, the new **rule** should require prominent, clear disclosure of a fund's limits on redeemability and prohibit the use of the term "mutual fund" and similar expressions in connection with these

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new companies. In other respects, the new kinds of funds should be regulated in the same manner as traditional open-end investment companies.

These new procedures would give shareholders the ability to invest in managed portfolios with less liquidity than mutual funds, while retaining the ability to exit the fund at a price based on net asset value.

Finally, because of the importance of portfolio liquidity to an investment company's ability to redeem or repurchase its shares, the Division recommends that:

The Commission should propose amending the Investment Company Act to make express a portfolio liquidity requirement for all companies that redeem or regularly repurchase their shares and to give the Commission authority to prescribe appropriate liquidity standards.

Liquidity requirements would help protect investors' reasonable expectations regarding their ability to exit a particular fund at net asset value.

Affiliated Transactions. The Investment Company Act has as one of its cornerstones strict prohibitions on transactions involving investment companies and their affiliates. These prohibitions go beyond those imposed by common law, by federal and state law on other types of pooled investment vehicles, such as bank common trust funds and commodities pools, or by foreign laws regarding investment companies. Because there is significant potential for abuse in many affiliated transactions, it would be unwise to make sweeping changes to the provisions of the Act concerning transactions involving investment companies and their affiliates, such as authorizing fund boards of directors to approve all such transactions. At the same time, however, some limited relief is appropriate to permit limited classes of transactions with affiliates that do not present significant conflicts, subject to review by boards of directors. Accordingly, the Division recommends that:

The Commission should amend the limitations on joint transactions under rule 17d-1 to broaden the class of transactions currently permitted by allowing directors of investment companies to authorize joint transactions with remote affiliates, and by exempting joint transactions where ~~an~~ investment company and its affiliates participate on the same terms, except ~~to~~ the extent of their participation.

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The Commission should adopt amendments to rule 10f-3, which allows limited purchases by investment companies from underwriting syndicates that contain affiliates, to permit purchases in overseas markets.

Procedures for Exemptive Orders. The authority to issue ~~orders~~ granting exemptions from the Act is vital to the Commission's ability to administer the Act flexibly and promptly in response to new developments in the financial markets. The large number of applications reviewed by the staff illustrates the extent to ~~which~~ the Commission and the industry depend on the process. In order to strengthen the ability of the ~~staff~~ and the Commission to respond promptly, the Division recommends that:

The Commission should adopt a rule providing for expedited treatment of routine applications for which there is recent, fully applicable precedent. Applicants employing this procedure generally would receive relief no later than ~~120~~ days after filing an application.

The Commission should expand the delegation of authority to the Division Director under existing regulations to expedite review of applications.

The Division believes that more radical revisions to the existing exemptive authority would be both unwise and unnecessary.

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## Chapter 1

# The Treatment of Structured Finance under the Investment Company Act

### I. Introduction and Summary of Recommendations

Structured finance is a financing technique in which financial assets, in many cases illiquid, are pooled and converted into capital market instruments.<sup>1</sup> In a typical structured financing, a sponsor transfers a pool of assets to a limited purpose entity, which in turn issues non-redeemable debt obligations or equity securities with debt-like characteristics ("fixed income securities"). Payment on the securities depends primarily on the cash flows generated by the assets in the underlying pool. Typically, the securities are rated in one of the two highest categories by at least one nationally recognized statistical rating organization ("rating agency"). Issuers that have more assets or that expect to receive more income than needed to make full payment on the fixed income securities also may sell interests in the residual cash flow.

Structured finance differs from conventional financing techniques in that it involves the pooling of financial assets, which are then removed from the sponsor's balance sheet. The risks inherent in holding the financial assets are shifted away from the sponsor to investors that believe they are in a better position to accept these risks? As a result, the sponsor may be able to manage its balance sheet better, while gaining access to alternative funding sources.

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<sup>1</sup>Although "structured finance" is the term most commonly used to describe this financing technique, the terms "structured securitized credit," "asset-backed arrangement," "asset-backed financing," and "asset securitization" also are used. We use these terms interchangeably throughout this chapter.

<sup>2</sup>See JAMES A. ROSENTHAL & JUAN M. OCAMPO, SECURITIZATION OF CREDIT: INSIDE THE NEW TECHNOLOGY OF FINANCE 5, 9-11 (sponsored and produced by McKinsey & Company Securitization Project; 1988). The sponsor **may** still bear some risk, depending on whether it provides recourse or owns some of the securities issued in the financing. *Id.*

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Since its inception in the 1970's, the structured finance market in the United States has grown rapidly.<sup>3</sup> One observer has estimated that \$292.8 billion of structured financing securities were issued in the United States in 1991, compared with \$174.0 billion in 1990.<sup>4</sup> The significance of the structured finance market is particularly apparent when its market share is compared to the market share of other types of offerings. In 1991, structured financings accounted for approximately fifty percent of total public securities issuances (debt and equity) in the United States, and approximately fifty-seven percent of total public debt securities issuances?

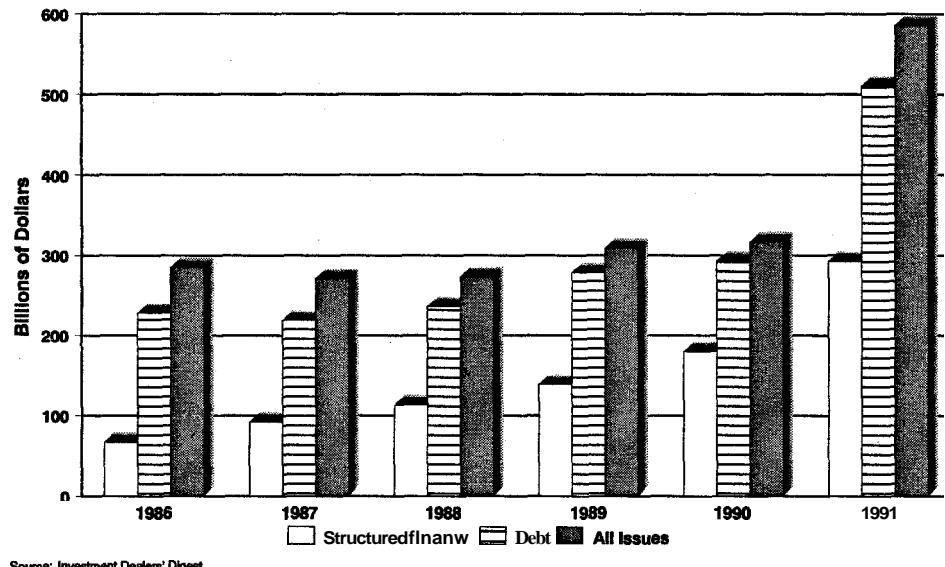
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<sup>3</sup>Structured finance is a form of "securitization." Although observers define "Securitization" in somewhat differing ways, generally it is the process by which funding that traditionally was obtained from commercial lenders, such as banks and finance companies, is obtained instead through the use of securities. See, e.g., *id.* at 3; LOWELL L. BRYAN, BREAKING UP THE BANK: RETHINKING AN INDUSTRY UNDER SIEGE 66-70 (1988). In addition to structured finance, other forms of securitization include commercial paper, loan participations and high yield bonds. See, e.g., BRYAN, *supra*, at 66, 69; TAMAR FRANKEL, SECURITIZATION: STRUCTURED FINANCING, FINANCIAL ASSETS POOLS, AND ASSET-BACKED SECURITIES, § 1.2, at 6 (1991).

<sup>4</sup>In 1991, approximately \$246.21 billion of mortgage-backed securities and \$46.60 billion of non-mortgage asset-backed securities were issued compared with reported issuance in 1990 of \$133.94 billion of mortgage-backed securities and \$40.10 billion of non-mortgage asset-backed securities. Michael Liebowitz, *Reversing Four-year Trend and Swooning Economy, Wall Street Explodes in 1991, INV. DEALERS' DIG.*, Jan. 6, 1992, at 26-27 [hereinafter *IDD 1991 Figures*].

<sup>5</sup>In 1991, an estimated \$585.97 billion of total United States debt and equity securities were issued of which \$510.96 billion were debt securities. *Id.* at 24, 27, 30-31. In comparison, in 1990, an estimated \$312.11 billion of total United States debt and equity securities were issued of which \$288.36 billion were debt securities. *Id.* As the foregoing figures indicate, although total structured finance issuances grew 68% from 1990 to 1991 (mostly as a result of an 84% increase in the issuance of mortgage-backed securities), both total securities issuances and total debt securities issuances grew even faster between 1990 and 1991 (88% and 77% respectively). Thus, from 1990 to 1991, structured finance issuances declined six percent as a portion of total securities issued and three percent as a portion of total debt securities issued.

**FIGURE 1-1**  
**Comparative Data Reflecting Growth of Structured Finance in the  
United States 1986-1991**



Source: Investment Dealers' Digest

Despite this robust growth, the Investment Company Act<sup>6</sup> has constricted the development and evolution of the structured finance market. Structured financings fall within the definition of investment company but cannot operate under the Act's requirements.<sup>7</sup> Many financings have avoided regulation under the Act by relying on the exception to the definition of investment company in section 3(c)(5), which Congress included in 1940 for the commercial finance and mortgage banking industries.<sup>8</sup> The Commission has granted exemptions with

<sup>6</sup>Investment Company Act of 1940, 15 U.S.C. § 80a.

<sup>7</sup>See generally *infra* Section IV.

<sup>8</sup>15 U.S.C. § 80a-3(c)(5).

'Certain federally sponsored structured financings, such as those sponsored by the Federal National Mortgage Association ("FNMA"), also are exempted from the Act's provisions under section 2(b), which exempts, among other things, activities of United States Government instrumentalities or wholly-owned corporations of such instrumentalities. 15 U.S.C. § 80a-2(b). The Division did not re-examine the treatment of federally sponsored structured financings under the Act.

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respect to other financings, primarily those involving mortgage-related assets.<sup>10</sup> Financings that are unable to rely on a statutory exception or obtain an exemptive order must sell their securities either privately to no more than 100 investors in reliance on the Act's private investment company exception, or outside the United States.<sup>11</sup> Thus, the Investment Company Act distorts the structured finance market, even driving some offerings offshore. The Act also causes much unproductive discussion over whether particular offerings may rely on section 3(c)(5).

In light of these problems, the Division has re-examined the Investment Company Act's treatment of private sector structured financings.<sup>12</sup> We recommend that the Commission adopt a rule exempting structured financings from all provisions of the Investment Company Act, subject to conditions that would address the investor protection concerns presented by structured financings.<sup>13</sup> The conditions generally would restrict "management" of exempt financings; prohibit the issuance of redeemable securities; limit public securities issuances to debt or debt-like securities that are rated in the top two investment

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<sup>10</sup>See *infra* Section IV.A.2.

<sup>11</sup>Investment Company Act § 3(c)(1), 15 U.S.C. § 3(c)(1).

<sup>12</sup>In the course of this examination, the Division met with representatives of entities associated with the structured finance industry to discuss, among other things, how structured financings work, the roles of the various participants, the status of the structured finance market, likely developments, and investor protection concerns. In addition, the Division published a request for comments on reform of the regulation of investment companies which included a request for comments on the regulation of structured financing under the Act. Request for Comments on the Reform of the Regulation of Investment Companies, Investment Company Act Release No. 17534, § III.C. (June 15, 1990), 55 FR 25322 [hereinafter Study Release]. The Division received many responses to the Study Release addressing structured finance issues including letters from The American Bankers Association; The 1940 Act Structured Finance Task Force of the American Bar Association; Banca D'Italia; Bankers Trust Company; Chase Manhattan Bank; Chemical Bank; Citicorp; Cleary, Gottlieb, Steen & Hamilton; Davis Polk & Wardwell; Dean Witter Reynolds Inc.; The Equitable Life Assurance Society of the United States; Federated Investors; Financial Security Assurance; Foley & Lardner on behalf of Smith Barney Asset Capital Corp.; Tamar Frankel; Investment Company Institute; Mayer Brown & Platt; Mayer Brown & Platt on behalf of Continental Bank N.A.; Merrill Lynch & Co., Inc.; New York Clearing House; Sears, Roebuck and Co.; and Shearson Lehman Brothers.

<sup>13</sup>Of course, structured financings are also subject to various regulatory requirements under the Securities Act of 1933 (15 U.S.C. §§ 77a-77aa), the Securities Exchange Act of 1934 (15 U.S.C. §§ 78a-78ll), and the Trust Indenture Act of 1939 (15 U.S.C. §§ 77aaa-77bbbb), as well as other federal laws and state laws. The Division examined only the Investment Company Act issues.

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grades, the payment of which depend on the cash flows from the underlying assets; and require independent trustees.

Section II of this chapter provides an overview of structured finance, discussing the present status of the market and how it began, which institutions are securitizing their assets and why, who purchases these securities, and expectations for the future. Section III discusses the basic mechanics of structured financings, including the responsibilities of the various entities involved. Section IV describes the application of the Investment Company Act to structured financings and its effects. Section V discusses whether structured financings should be subject to the Act, examining whether structured financings present the potential for the type of abuses the Investment Company Act is designed to remedy and, if so, how structured financings could be regulated under the Act. Section V also analyzes possible reforms, including several of those suggested by commenters in response to the Division's request for comments on reform of the regulation of investment companies (the "Study Release"),<sup>14</sup> and discusses the Division's proposed rule.

## II. Overview of Structured Finance

### A. The Structured Finance Market

#### 1. The Mortgage Market

The modern structured finance market originated in the 1970's with the securitization of residential mortgages.<sup>15</sup> Since then, securities backed by residential mortgages have dominated the structured finance market. As of September 30, 1991, the aggregate amount of securities backed by one- to four-family mortgages was reported to be \$1.2 trillion, representing forty-two percent of all mortgage debt.<sup>16</sup> Total value of mortgage-backed securities issued in 1991

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<sup>14</sup>Study Release, *supra* note 12.

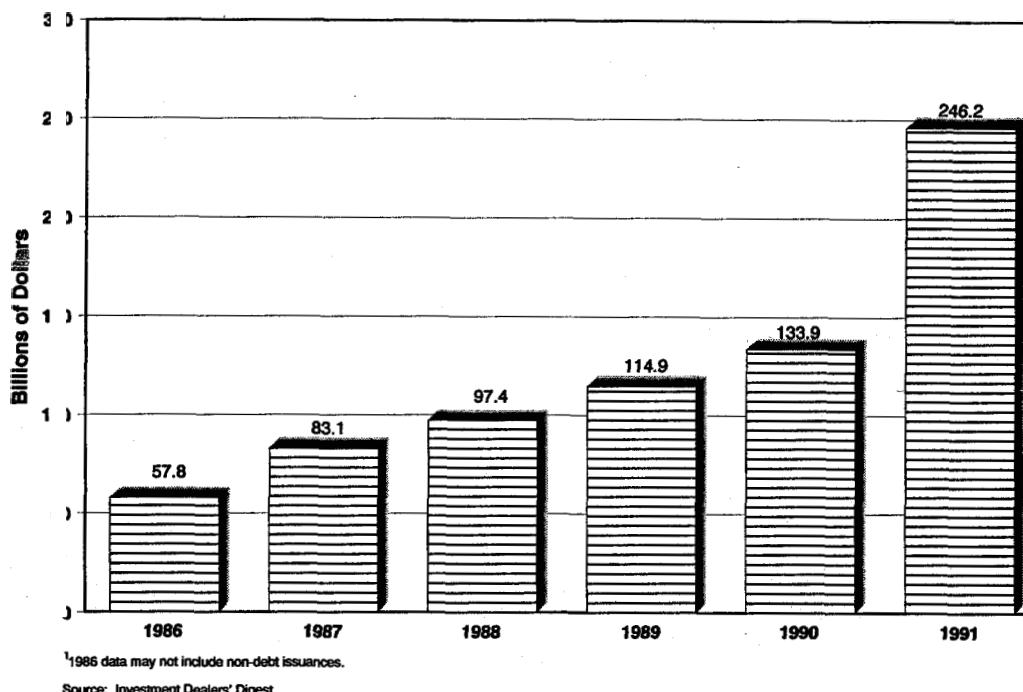
<sup>15</sup>Mortgages were "securitized," in crude fashion, in the 1920's and 1930's. Typically, banks or mortgage insurers guaranteed the mortgages. Many of the mortgage pools experienced defaults and many of the guarantors failed, as a result of inadequate capital. Edward L. Pittman, *Economic and Regulatory Developments Affecting Mortgage Related Securities*, 64 NOTRE DAME L. REV. 497,500 (1989).

<sup>16</sup>Federal Home Loan Mortgage Corp., *Database, Securitized Mortgage Debt Outstanding*, in THE SECONDARY MORTGAGE MARKETS Table 5 (Winter 1991/1992) [hereinafter *Database*.] In contrast, as of the same date, only 10% of all outstanding multi-family mortgage debt had been securitized. *Id.*

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was estimated to be \$246.2 billion, an eighty-four percent increase from the 1990 level of \$133.9 billion.<sup>17</sup> Figure 1-2 illustrates the growth of the mortgage market.

**FIGURE 1-2**  
**Mortgage-Backed Securities Issued in the United States 1986-1991<sup>1</sup>**



The securitization of residential mortgages is a direct outgrowth of federal promotion of the secondary market in residential mortgages.<sup>18</sup> The Government National Mortgage Association ("GNMA"), the Federal National Mortgage Association ("FNMA"), and the Federal Home Loan Mortgage Corporation ("FHLBC") were formed to provide greater access to capital for residential

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<sup>17</sup>IDD 1991 Figures, supra note 4, at 21. It is likely that only a small dollar amount of securitized commercial mortgages is included in this figure. For a discussion of securitization of commercial mortgages, see note 36 and accompanying text below.

<sup>18</sup>See, e.g., BRYAN, supra note 3, at 71.

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mortgage financing through development of a secondary market for residential mortgages.<sup>19</sup> FNMA and FHLMC promote the secondary mortgage market in part by purchasing mortgages and either holding the mortgages or selling them, in the latter case primarily by repackaging the mortgages into securities. GNMA primarily guarantees payment on the securities issued by mortgage pools that are created by financial institutions.

In 1970, GNMA created the first publicly traded mortgage-backed security.<sup>20</sup> The security, known as a mortgage pass-through certificate, represented beneficial ownership of a fractional undivided interest in a fixed pool of residential mortgage loans. GNMA guaranteed timely payment of principal and interest on the certificates. Both FNMA and FHLMC subsequently issued mortgage-backed securities; and, like GNMA, embarked on mortgage-backed securities programs ("agency programs"). The FNMA and FHLMC programs differ from the GNMA program in two significant ways. First, both FNMA and FHLMC themselves issue securities, while GNMA guarantees securities issued by

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<sup>19</sup>FNMA was created by Congress in **1938** as a wholly-owned government corporation for the purpose of providing a secondary mortgage market for Federal Housing Administration ("FHA") and later Veterans Administration ("VA") mortgage loans. In **1968**, pursuant to Title VIII of the Housing and Urban Development Act of **1968** (Pub. L. No. **90-448**, Title VIII, § **801**, Aug. **1**, **1968**, **82 Stat. 536**) (codified at **12 U.S.C. § 1716b**), FNMA was divided into two separate entities. One continued to be called FNMA, but became a privately owned entity, subject to the regulatory authority of the Department of Housing and Urban Development ("HUD"). **12 U.S.C. § 1723(b)**. FNMA continues to provide a secondary market for FHA and VA mortgage loans, and, in **1970**, was authorized to do the same for certain other mortgage loans. **12 U.S.C. § 1718**. The other entity became GNMA, an instrumentality within HUD that generally services the portfolio of mortgages owned by the federal government. GNMA also guarantees securities issued by HUD-approved mortgagees that represent interests in pools of mortgages comprised solely of FHA, VA, and certain Farm Housing Administration loans. FHLMC was created in **1970**, pursuant to Title III of the Emergency Home Finance Act of **1970** (**12 U.S.C. §§ 1451-1459**), to develop and maintain a nationwide secondary market for conventional residential mortgages issued by savings and loans, mortgage bankers, banks, and HUD-approved mortgagees. Under the Financial Institutions Reform, Recovery and Enforcement Act of **1989** ("FIRREA"), FHLMC became privately owned, subject to the regulatory authority of HUD. Pub. L. No. **101-73**, Title VI, § **731(b)-(e)**, **103 Stat. 183**, **429-435** (Aug. **9, 1989**) (codified as amended at **12 U.S.C. §§ 1451-1459**).

<sup>20</sup>See **KENNETH G. LORE**, MORTGAGE-BACKED SECURITIES DEVELOPMENTS AND TRENDS IN THE SECONDARY MORTGAGE MARKET **2-4** (1991-92 ed.). Mortgage-backed securities differ from mortgage-backed bonds, which were offered to the public as early as **1880**. Mortgage-backed bonds are general obligations of an issuer that are secured by a pool of mortgage loans or mortgage securities. Payment of these bonds does not necessarily depend on the underlying cash stream from the mortgage pool; it may come from the issuer's general funds. See Pittman, *supra* note 15, at 500.

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others. Second, unlike the GNMA program, securities issued by FNMA and FHLMC are not backed by the full faith and credit of the United States. Because of FNMA and FHLMC's close association with the federal government, however, securities issued by them are perceived by many to be virtually as safe as **GNMA** securities.<sup>21</sup>

The design of the agency programs, as well as the characteristics of the residential mortgages in each program's portfolio, greatly simplify the securitization of mortgages. The agencies generally purchase only a relatively homogenous class of these mortgages; accordingly, these mortgages meet similar credit criteria and have similar maturities. The large volume of loan originations and the relatively small principal amounts of the loans simplify securitization by facilitating credit and cash flow analysis, among other things. Finally, the perception of a federal guaranty backing the instruments, whether explicit or implicit, promotes investor acceptance.

The development by FHLMC, GNMA, and FNMA of mortgage-backed securities ("agency securities" or "agency certificates") promoted residential mortgage financing. By increasing the liquidity of the secondary residential mortgage market, the agency programs have reduced the cost of borrowing by lowering interest rates and origination fees.<sup>22</sup> The agency programs also contributed to the innovation of new mortgage forms by creating a variety of new mortgage securities products.<sup>23</sup> For example, in 1983, FHLMC created the collateralized mortgage obligation ("CMO"). A CMO is a debt obligation whose structure allows the cash flows on the underlying mortgage pools to be carved up into separate classes of securities, called "tranches," each with a specified coupon

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<sup>21</sup>See, e.g., LORE, *supra* note 20, at 1-8; Pittman, *supra* note 15, at 500. See also Peter V. Darrow, et al., *Rating Agency Requirements*, in 1 SECURITIZATION OF FINANCIAL ASSETS § 7.02[G], at 7-44 to 7-45 (Jason H.P. Kravitt ed. 1991).

<sup>22</sup>Rosenthal and Ocamporeported (in 1989)that "[h]ome buyers are now paying approximately 100 basis points less in interest (versus U.S. Treasury yields) on fixed-rate mortgages than they were a decade ago when mortgage securitization was much less pervasive." ROSENTHAL & OCAMPO, *supra* note 2, at 12. See also LORE *supra* note 20, at 1-12 (FHLMC's annual report indicated that interest rates on mortgages that qualify for sale to FHLMC are about one-half of a percentage point lower than nonconforming mortgages). But see Pittman, *supra* note 15, at 542-543 (as of 1986, the Federal Reserve Board did not credit SMMEA with any decrease in interest rates available to homeowners nor did it anticipate that SMMEA would effect any significant reduction in the future); BRYAN, *supra* note 3, at 86 (in 1988, a reduction in mortgage rates had not yet occurred although the author viewed that result as inevitable, eventually).

<sup>23</sup>WILLIAM W. BARTLETT, MORTGAGE-BACKED SECURITIES 12 (1989).

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and stated maturity. Scheduled payments and prepayments from the mortgage pool are allocated to retire the classes in the order of stated maturities.<sup>24</sup>

The three agency programs dominate the secondary residential mortgage market<sup>25</sup> but the private sector has also participated in issuing mortgage-backed securities. Mortgage-backed securities issued by the private sector have typically been backed by agency certificates and conventional mortgages that the sponsor either originates itself or purchases in the secondary market. Many of the conventional mortgages have balances exceeding the maximum loan limits permitted to be purchased by the agencies ("nonconforming loans").<sup>26</sup> These securities also lack the guaranty of the agency securities, a significant handicap to the private sector in the secondary residential mortgage market.<sup>27</sup>

In an effort to expand the participation of the private sector in the secondary market, Congress enacted the Secondary Mortgage Market Enhancement Act of 1984 ("SMMEA").<sup>28</sup> Congress was concerned that the agencies would not be able to meet future demands for mortgage credit. SMMEA removed obstacles for privately sponsored mortgage-backed securities by, among

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<sup>24</sup>The CMO structure followed a prior unsuccessful attempt to devise a multiclass mortgage security. In 1983, Sears Mortgage Securities Corporation introduced a multiple class pass-through security, which was unsuccessful because it received unfavorable tax treatment by the Internal Revenue Service ("IRS"). *Pittman, supra* note 15, at 505-506. In 1986, Congress effectively overruled the IRS in this matter by enacting the Real Estate Mortgage Investment Conduit ("REMIC") provisions in the Tax Reform Act of 1986. Pub. L. No. 99-514, §§ 671-675, 100 Stat. 2085,2309-2320(1986), codified at 26 U.S.C. §§ 860A-860G. See *Pittman, supra* note 15, at 505,508. For more discussion of CMOs and REMICs, see *infra* notes 146-151 and accompanying text.

<sup>25</sup>For example, in 1990, FHLMA, GNMA and FNMA together issued \$235 billion in pass-through securities out of a total pass-through issuance of \$249 billion, thus giving the agencies 94.2% of total pass-through issuances in 1990. *Database, supra* note 16, at Table 2, Part A. In addition, in 1990, FHLMA and FNMA combined issued \$97.5 billion in multiclass mortgage securities (CMOs and REMICs) out of a total multiclass issuance of \$118.6 billion, thus giving the agencies 82.2% of total multiclass issuances in 1990. *Id.* at Table 3. In the first three quarters of 1991, FNMA and FHLMC increased their market domination, issuing 94.2% of all multiclass mortgage-backed securities offered. *Id.*

<sup>26</sup>LORE, *supra* note 20, at 1-14.

<sup>27</sup>David Abelman, *The Secondary Mortgage Market Enhancement Act*, 14 REAL ESTATE L. J. 136, 145-147 (1985).

<sup>28</sup>The Secondary Mortgage Market Enhancement Act of 1984, Pub. L. No. 98-440, 98 Stat. 1689 (1984) (codified at scattered sections of 12 and 15 U.S.C.).

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other things, pre-empting certain state investment laws so that state regulated institutions might purchase privately sponsored mortgage-backed securities to the same extent as agency securities, granting authority for certain depository institutions to invest in these securities, and requiring states to exempt privately sponsored mortgage-backed securities from state registration to the same extent as agency securities, unless the state specifically deemed otherwise.<sup>29</sup>

Despite SMMEA, the private sector has not made significant inroads in the secondary residential mortgage market. Indeed, in 1989, the dominance of the agencies grew even greater as private issuance slowed in response to problems in the financial market, the loss in 1986 of tax incentives, and the savings and loan crisis.<sup>30</sup> Issuance of privately sponsored pass-through certificates dropped by more than forty percent between 1988 and 1989 causing a **6.4%** decline in market share.<sup>31</sup> More dramatically, the market share of publicly offered multiclass securities (e.g., CMOs) issued by the private sector dropped almost fifty percent between 1988 and 1989.<sup>32</sup> In 1990, the market share of privately sponsored pass-through certificates held steady,<sup>33</sup> while the market share of privately sponsored multiclass securities recovered slightly only to dip again in the first three quarters of 1991.<sup>34</sup>

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<sup>29</sup>For more information on SMMEA, see Pittman, *supra* note 15; Abelman, *supra* note 27.

<sup>30</sup>LORE, *supra* note 20, at 2-39.

<sup>31</sup>In 1988, non-agency sponsors issued approximately **\$20.7** billion of pass-through securities representing **12.1%** of total issuance (**\$170.6** billion). *Database*, *supra* note 16, at Table 2, Part A. In 1989, non-agency sponsors issued only **\$12.2** billion of pass-throughs representing **5.7%** of total issuance (**\$212.6** billion). Id. Although the volume of non-agency sponsored pass-through securities increased to approximately **\$14.3** billion in 1990, total issuance also increased to **\$249.3** billion leaving the non-agency sponsors' market share the same as 1989. Id.

<sup>32</sup>In 1988, non-agency sponsors issued **\$51.0** billion of multiclass securities out of a total volume of **\$76.8** billion for **66.4%** of the multiclass mortgage market. Id. at Table 3. In 1989, non-agency sponsors experienced a precipitous **49.8%** drop in multiclass market share (and a **67.3%** drop in volume) issuing **\$16.7** billion of multiclass securities out of a total volume of **\$100.5** billion or **16.6%** of the multiclass mortgage market. Id.

<sup>33</sup>See *supra* note 31.

<sup>34</sup>In 1990, non-agency sponsors issued **\$21.1** billion of multiclass securities out of a total volume of **\$118.6** billion for a slight market share increase to **17.8%** of the multiclass mortgage market. *Database*, *supra* note 16, at Table 3. In the first three quarters of 1991, however, non-agency sponsors issued only **\$10.5** billion of multiclass securities out of a total volume of **\$137.6** billion for a mere **7.6%** of the multiclass market, of which **\$2.5** billion or **1.8%** consisted of  
(continued...)

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The private sector has begun to securitize commercial mortgages and mortgage products. Sponsors have publicly offered securities backed by small commercial loans, large single mortgages on office buildings, and commercial mortgage loans in the form of tax-exempt industrial development bonds.<sup>35</sup> The development of these securities has been slowed, in part, by the lack of standardization in loan structure and documentation and soft real estate markets.<sup>36</sup>

In addition to the public mortgage market, there have been a number of private placements of mortgage products. Private placement of securities backed by residential mortgages apparently is unusual. The opposite is true for commercial mortgages, with many, if not most, commercial mortgage-backed securities sold in private placements, perhaps because of the lack of standardization.<sup>37</sup>

## 2. The Non-Mortgage Market

Since the mid-1980's the techniques pioneered in the secondary residential mortgage market have been used by the private sector to securitize other assets. As of year-end 1991, approximately \$158.34 billion of non-mortgage asset-backed

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<sup>34</sup>(...continued)  
securities issued under the securitization program of the Resolution Trust Corporation (the "RTC"). Id. For further information about the RTC's securitization program, see *infra* notes 96 & 97 below and accompanying text.

<sup>35</sup>PAVEL, *supra* note 43, at 77-78.

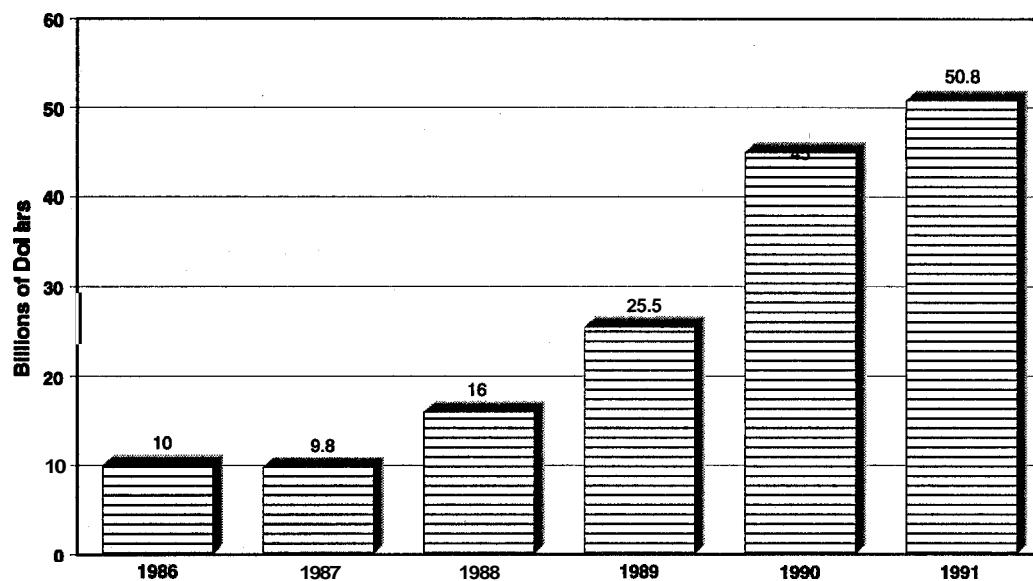
<sup>36</sup>See LORE, *supra* note 20, at 1-3, 1-6, 2-41. See also Suzanne Wittebort, *Asset-Buck & Come of Age*, INSTITUTIONAL INVESTOR, Dec. 1991, at 80 ("[M]ortgages on commercial property tend to be more individualized and cash flows on a package of them can be lumpy."').

<sup>37</sup>Wittebort, *supra* note 36, at 80 (reporting that most of the anticipated commercial mortgage-backed structured financings in 1991 would be issued in private placements). Standard & Poor's ("S&P") has estimated that 75% of the commercial mortgage-backed securities it has rated have been privately placed. See *Commercial Mortgage Securitization -- It's Time Has Come*, STANDARD & POORS CREDIT REVIEW COMMERCIAL MORTGAGE SECURITIES, Apr. 8, 1991, at 3. But see LORE, *supra* note 20, at 1-3, 2-42 (the earliest commercial mortgage-backed securities issuances took place in the private market but subsequently the market saw a series of public transactions involving pools of smaller commercial mortgages).

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securities had been publicly issued.<sup>38</sup> One observer has estimated that the volume of non-mortgage asset-backed public issuances in 1991 totalled approximately \$50.8 billion, up from a \$10 billion total in 1986.<sup>39</sup>

**FIGURE 1-3**  
**Non-Mortgage Asset-Backed Securities issued in the**  
**United States 1986-1991**



Source: Dean Witter Reynolds, Inc.  
Asset-Backed Securities Reference Guide  
Year Ended 1991

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<sup>38</sup>DEAN WITTER REYNOLDS, INC., ASSET-BACKED SECURITIES REFERENCE GUIDE A-22 (Year Ended 1991) [hereinafter DEAN WITTER]. This figure is still dwarfed by the aggregate amount of mortgages securitized, which was estimated as of September 30, 1991 to have amounted to \$1.2 trillion. See *supra* note 16 and accompanying text.

<sup>39</sup>*Id.* at A-10. But see *IDD* 1992 *Figures*, *supra* note 4, at 22 (reporting \$46.6 billion of asset-backed securities issued in 1991).

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Securities backed by automobile loans and credit card receivables represent approximately eighty percent of the public non-mortgage asset-backed market and also constitute by far the two largest segments of that market.<sup>40</sup> In 1991, securities backed by credit card accounts receivable represented approximately forty-three percent of the non-mortgage asset-backed securities issuances.<sup>41</sup> Other assets presently being securitized publicly include home equity loans,<sup>42</sup> boat loans, computer leases, airplane leases, mobile home and recreational vehicle loans, vacation timeshares, hospital accounts receivable, Small Business Administration loans,<sup>43</sup> and industrial development bonds backed by different types of assets, including equipment leases.<sup>44</sup>

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<sup>40</sup>As of year-end 1991, securities backed by credit card receivables and automobile loans together amounted to \$129.4 billion out of \$158.3 billion total asset-backed securities original issuance. DEAN WITTER, *supra* note 38, at A-16. Financings backed by automobile loans were among the first non-mortgage structured financings publicly offered, and, until recently, represented the largest segment of the public market. *Id.* at A-17. By year-end 1991, financings backed by credit card receivables had surpassed automobile loan transactions in market share of outstanding securities. *Id.* at A-16.

<sup>41</sup>*Id.* at A-16. In 1991, credit card receivables backed the issuance of \$21.6 billion out of a total issuance of \$50.8 billion in non-mortgage asset-backed securities. *Id.* at A-1.

<sup>42</sup>Technically, home equity loans are mortgage products. Nevertheless, because home equity loans have many of the same characteristics as credit card receivables, structured financings backed by these loans are considered by many to be part of the non-mortgage asset-backed market.

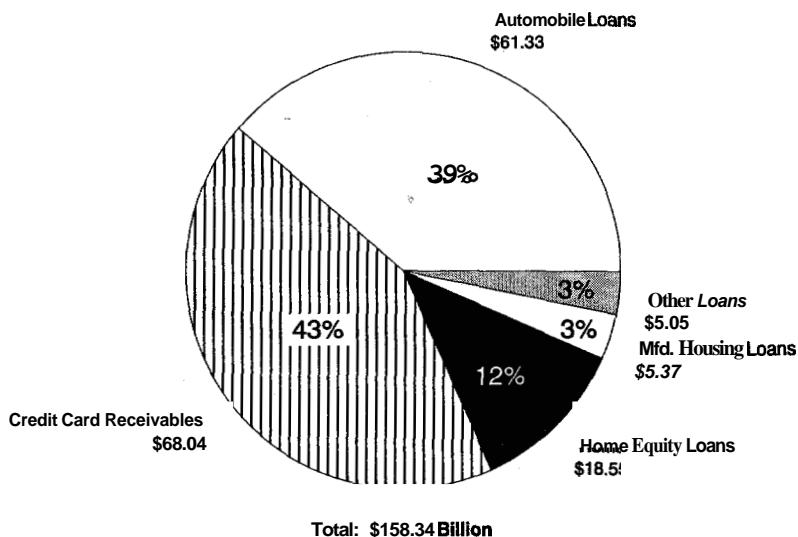
<sup>43</sup>The Small Business Secondary Market Improvements Act of 1984(Pub. L. No. 98-352, 98 Stat. 329 (1984) (codified at 15 U.S.C. §§ 633-634, 639)), authorized the Small Business Administration ("SBA") to establish a program for securitizing SBA loans. SBA also acts as a guarantor of such securities packaged by the private sector. For a more detailed discussion of such securities, see CHRISTINEA. PAVEL, SECURITIZATION 152-155 (1989).

<sup>44</sup>See DEAN WITTER, *supra* note 38, *passim*.

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FIGURE 1-4

Total Issuance of Non-Mortgage Asset-Backed Securities by Collateral Type



Source: Dean Witter Reynolds, Inc.  
Asset-Backed Securities Reference Guide  
Year Ended 1991

Most of the assets that have been securitized have homogeneous characteristics, including similar terms, structures, and credit characteristics.<sup>45</sup> The assets tend to have payment streams with proven histories of performance, which in turn make future payments reasonably predictable. These characteristics facilitate analysis of the credit risks.

Other types of assets lack the homogeneity necessary for easy credit risk analysis and therefore are just beginning to be securitized. For example, non-performing loans, middle market loans, and other types of commercial loans are in the beginning stages of securitization.<sup>46</sup> The obstacles associated with

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<sup>45</sup>PAVEL, supra note 43, at 17-20.

<sup>46</sup>Id. See also Christopher L. Snyder, Jr., Securitizing Middle Market *Loans* in THE ASSET SECURITIZATION HANDBOOK 440-476 (Phillip Zweig ed., 1989) [hereinafter THE ASSET SECURITIZATION HANDBOOK]. But see Jean-Louis LeLogeais and Don Kerr, Applying the Strategic View to Asset *Securitization* Decisions, AM. BANKER (Special Adv. Supp.), May 30, 1989, at 4A to 5A. (Securitization is prohibitively expensive for banks whose asset mix is concentrated in the middle market with its relatively higher spreads and returns; this is true because of the nonuniform nature of business risks and the inherent inability to pool loans effectively.)

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securitizing these assets include the lack of reliable data on losses, uniform underwriting and collection standards, standardized documentation, and similar loan balances. In addition, the transaction must be structured so that credit risk analysis can be accomplished without loan-by-loan review.<sup>47</sup>

A number of non-mortgage, asset-backed securities have been privately placed. Although some of these securities are similar to those sold publicly,<sup>48</sup> many private placements involve types of structured financings that have never been publicly offered in the United States, in part because of the Investment Company Act. For example, financings backed by high yield bonds ("collateralized bond obligations" or "CBOs"), installment loans, future royalties, and Medicare and Medicaid receivables have all been issued in private placements, but have never been sold publicly in the United States.

## B. Sponsors of Structured Financings

With the exception of the federal government and federally sponsored entities, the most active sponsors of structured financings are commercial banks and savings and loans. In 1988, the last year the private sector was relatively active in the residential mortgage-backed securities market, the major issuers were savings and loans, responsible for half of private sector mortgage-backed issuances, and commercial banks, responsible for fourteen percent of such issuances in 1988.<sup>49</sup> Other active sponsors of residential mortgage-backed securities in 1988 included investment banks (twenty-four percent), insurance

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<sup>47</sup>See Peter Haidorfer, *Assessing Consumer Debt Risk is Vital for Credit Enhancers*, AM. BANKER (Special Adv. Supp.), May 30, 1989, at 10A to 11A.

<sup>48</sup>Some of the first sales of assets now commonly securitized and sold publicly were initially sold in private placements. For example, the first structured financing backed by credit card receivables was placed privately in March 1986, with the first public transaction occurring in 1987. See PAVEL, *supra* note 43, at 109.

<sup>49</sup>LORE, *supra* note 20, at 2-38 to 2-39.

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companies (eight percent), and conduits<sup>50</sup> (four percent).<sup>51</sup> Although these types of entities continue to sponsor mortgage-backed securities, since 1989 their volume and market share have dropped considerably **with** the increase in the strength of the agency programs.<sup>52</sup>

In the non-mortgage market, as of year-end 1991, commercial banks had originated approximately 45.6% of total issuances.<sup>53</sup> Other sponsors included auto manufacturers (28.0%), retailers (7.1%), and savings and loans (5.5%).<sup>54</sup>

From a sponsor's perspective, there are sound reasons to securitize assets.<sup>55</sup> The sponsor may be better able to manage its loan portfolio, and, in turn, its balance sheet: asset securitization permits a sponsor to convert financial assets into cash, which can be used to retire debt or acquire new receivables. Asset securitization can increase the liquidity of a loan portfolio, permitting a sponsor to select the financial assets it wishes to keep, and to sell the assets it does not want. Asset securitization also permits a sponsor to reduce its interest rate risk resulting from its funding fixed-rate, long-term assets with floating rate and/or short-term liabilities, a particularly attractive option in times of volatile interest rates.<sup>56</sup> Alternatively, by selling portions of portfolios concentrated in

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<sup>50</sup>A mortgage conduit is an organization that purchases mortgages, packages the mortgages into pools, and sells the mortgages through the capital markets. For information on the evolution of conduits, see BARTLETT, *supra* note 23, at 9-11.

<sup>51</sup>LORE, *supra* note 20, at 2-38 to 2-39.

<sup>52</sup>See *supra* notes 30-36 and accompanying text. See also LORE, *supra* note 20, at 2-38.

<sup>53</sup>DEAN WITTER, *supra* note 38, at A-26.

<sup>54</sup>*Id.*

<sup>55</sup>Originators that sell assets to a financial intermediary, such as a conduit, that in turn sponsors a structured financing backed by the assets, receive many of the same benefits as originators that sponsor a financing. Originators may choose to sell to these intermediaries if they do not hold enough assets to make sponsorship economical.

<sup>56</sup>See, e.g., Thomas R. Boemio & Gerald A. Edwards, Jr., *Asset Securitization: A Supervising Perspective*, 75 FED. RES. BULL. 659, 663 (1989); BRYAN, *supra* note 3, at 85; ROSENTHAL, *supra* note 2, at 10-13. Savings and loans, for example, securitized portions of their mortgage portfolios in part to address risks of rising interest rates. Mortgage loans traditionally had maturities of 30 years and had fixed interest rates. By contrast, 65% of a typical savings and loan's liabilities are time and savings deposits that mature in less than one year. See Pittman, *supra* note 15, at 501. In response to increasing competition from national residential mortgage originators, savings and (continued...)

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a single industry or geographic area, for example, a sponsor may use structured financings to diversify its credit risk.<sup>57</sup>

By being better able to manage its loan portfolio, a sponsor also can strengthen its financial condition. Removing certain assets from the balance sheet can boost the return on assets and on equity. If the transaction is considered to be a sale of assets, income recognition may be accelerated by permitting the sponsor to realize a gain (or loss) upon sale.<sup>58</sup> Income may also be recognized from previously deferred loan fees.

Structured financings also allow sponsors to gain access to alternative funding sources.<sup>59</sup> Some sponsors, particularly those that enter the capital markets frequently, find it useful to be able to offer new instruments. In addition, structured financings allow sponsors to broaden their investor base.<sup>60</sup>

Structured financings also provide sponsors with access to funding sources that, depending on the sponsor's credit rating, may be less expensive and more feasible than traditional sources.<sup>61</sup> Because securitized assets usually are no longer assets of the sponsor, the structured financing may be rated independently of the sponsor's rating. Sponsors find structured financings particularly beneficial during economic downturns when there frequently is widespread downgrading of corporate credit, making the issuance of corporate debt or equity through the markets less attractive.<sup>62</sup>

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<sup>56</sup>(...continued)

**loans also have used structured financing to lower their costs of funding and to sell off assets with inadequate spreads.** *Innovations in Thrift Financing: Opportunity and Risk*, MOODY'S STRUCTURED FINANCE RESEARCH & COMMENTARY, Aug. 1987, at 3.

<sup>57</sup>See, e.g., BRYAN, *supra* note 3, at 82-83; Boemio & Edwards, *supra* note 56, at 663; ROSENTHAL, *supra* note 2, at 9-10; Wittebort, *supra* note 36, at 78.

<sup>58</sup>Boemio and Edwards, *supra* note 56, at 663.

<sup>59</sup>See, e.g., BRYAN, *supra* note 3, at 84.

<sup>60</sup>See, e.g., Wittebort, *supra* note 36, at 78.

<sup>61</sup>See, e.g., BRYAN, *supra* note 3, at 81-82, 124.

<sup>62</sup>See Richard Benson, *Recession and Credit Crunch Will Spur Asset Securitization*, MORTGAGE-BACKED SEC. LETTER, Nov. 12, 1990, at 8.

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Banks have been particularly active in using structured financings.<sup>63</sup> This activity can be traced in part to the severe financial pressures in the United States banking industry. Bank credit quality steadily declined throughout the 1980's, with a considerable acceleration of this decrease occurring within the last few years as a result of deterioration of real estate assets and loans to highly leveraged borrowers.<sup>64</sup> The deteriorating quality of bank assets has resulted in a significant number of downgrades of the credit ratings of United States banks.<sup>65</sup>

In some cases, structured financings may provide regulatory benefits for banks, savings and loans, and other regulated entities, by enabling them to meet their reserve and capital requirements. For example, banking and thrift regulatory agencies have adopted "risk-based" capital requirements for depository institutions<sup>66</sup>. The risk-based capital requirements for banks assign assets and credit equivalent amounts of off-balance sheet items to risk categories, depending on each asset's level of credit risk.<sup>67</sup> The level of capital that a bank must maintain depends on the level of risk -- or "risk weight" -- assigned to that bank's assets. Many banks have had to increase their capital ratios to meet these requirements, but, because of market concerns about their creditworthiness, have

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<sup>63</sup>See, e.g., Boemio & Edwards, *supra* note 56, at 662.

<sup>64</sup>Andrew Freeman, *Credit Downgrades on US Banks Predominate amid Asset Worries*, FIN. TIMES, Aug. 16, 1990, at 19. See also *Bank Profitability in the 1990's*, FITCH RESEARCH FINANCIAL INSTITUTIONS (Special Report), Dec. 20, 1991, at 2.

<sup>65</sup>See *Pressures on U.S. Bank Ratings*, Presentation by Christopher T. Mahoney, Vice President/Associate Director, Financial Institutions Group, Moody's Investor's Service, to the American Bankers Association CFO Forum, New York, September 11, 1990 in MOODY'S STRUCTURED FINANCE RESEARCH AND COMMENTARY, Oct. 1990, at 9. See also *U.S. Money Center Banks*, MOODY'S INDUSTRY OUTLOOK, Aug. 1990, at 4.

<sup>66</sup>Risk-based capital requirements are set forth at 12 C.F.R. pt. 3, App. A (for national banks); 12 C.F.R. pt. 208, App. A (for state member banks insured by the Federal Deposit Insurance Corporation ("FDIC")); 12 C.F.R. pt. 225, App. A (for bank holding companies); 12 C.F.R. pt. 325, App. A (for FDIC-insured state non-member banks); and 12 C.F.R. pt. 567 (for savings associations). For a general discussion of risk-based capital requirements, see, e.g., Michael G. Capatides, et al., *Bank and Savings and Loan Association Regulatory Considerations*, in 2 SECURITIZATION OF FINANCIAL ASSETS, *supra* note 21, § 12.03 at 12-19 to 12-38; FRANKEL, *supra* note 3, § 7.14, at 224-234.

<sup>67</sup>For example, most securities issued or unconditionally guaranteed by United States government agencies are assigned a zero percent risk weight. 12 C.F.R. pt. 3, App. A, § 3(a)(1)(iii) & (iv). An example of a high risk (100% risk weight) asset is stripped mortgage-backed securities (12 C.F.R. pt. 3, App. A, § 3(a)).

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had difficulties raising the necessary capital.<sup>68</sup> To meet their capital needs, many banks have sponsored structured financings, either by securitizing assets, such as credit-card receivables, or, less frequently, by setting up "bad banks" whereby non-performing loans are sold to newly created entities chartered as banks, whose primary function is to liquidate these assets. Structured financings have enabled banks to meet risk-based capital requirements by securitizing "higher risk-weighted assets" and either taking the sale proceeds and purchasing "lower risk-weighted risk assets" (which require less capital), or keeping the proceeds in cash or other liquid assets.

Even without higher capital requirements, structured financings may be very attractive for banks.<sup>69</sup> In addition to obtaining capital by selling their assets through structured financings, banks may also obtain funding by retaining the servicing rights to those assets and retaining a possibly economically valuable residual interest.<sup>70</sup> Also, structured financings can benefit banks by increasing the liquidity of their loan portfolios.<sup>71</sup>

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<sup>68</sup>For a discussion of the use of securitization by banks and bank holding companies to manage their risk-based capital and capital adequacy requirements, see Boemio and Edwards, *supra* note 56, at 664-669.

<sup>69</sup>It has been argued that even a bank with a AAA rating would benefit in terms of capital cost savings by securitizing those high-quality assets for which regulatory capital requirements overestimate actual expected credit losses. See BRYAN, *supra* note 3, at 83.

<sup>70</sup>For a discussion of residual interests, see infra notes 143-145 and accompanying text. By retaining the servicing rights to the assets, banks may continue existing lending relationships with their customers even though the original loans are no longer on their balance sheets.

<sup>71</sup>The advantages of increased liquidity are discussed *supra* notes 55-56. Some observers believe that structured financings could lead to a more stable and less costly financial system. See ROSENTHAL & OCAMPO, *supra* note 2, at 13-17, 21. See also PAVEL, *supra* note 43, at 227-229 (suggesting a variety of scenarios in which securitization would help to make the banking system more efficient). Others have suggested that the technology of structured financing could be used to help restructure the banking industry. One observer has written that the technology of structured financing would enable the banking industry to separate the depositing and lending functions of a bank and permit banks to establish separate businesses around the functions that it is the most capable of delivering at the best price. This would address what the observer believes is one of the fundamental flaws of the present banking system, the cross-subsidy of deposits and loans, and promote a competitive banking environment, with only the depository institutions being protected by a federal guarantee. BRYAN, *supra* note 3, at vii-x, 92-98, and *passim*.

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## C. Purchasers of Structured Financings

### 1. Institutional Investors

Institutional investors, including banks, savings and loans, pension funds, insurance companies, and money managers have been the predominant purchasers of asset-backed issues.<sup>72</sup> These investors find asset-backed securities attractive for several reasons. First, institutional investors generally consider most asset-backed securities to be relatively safe investments because such securities generally are highly rated by one or more rating agencies.<sup>73</sup> Also, in many instances, institutional investors conduct their own due diligence review prior to investing.<sup>74</sup> Second, the securities typically offer returns that are higher than those of United States Treasury securities with comparable maturities.<sup>75</sup> Third, some asset-backed securities, such as certain mortgage-backed securities, are relatively liquid, enabling the investors to resell the securities to meet changed portfolio objectives or new liquidity needs. Fourth, most agency securities and

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<sup>72</sup>ROSENTHAL & OCAMPO, *supra* note 2, at 13; LORE, *supra* note 20, at 2-48. See also Boemio and Edwards, *supra* note 56, at 663. Until recently, savings and loans were the largest holders of mortgage-backed securities. Their share of this market has shrunk, in part, because undercapitalized savings and loans must sell substantial amounts of assets. KENNETH G. LORE, MORTGAGE-BACKED SECURITIES: DEVELOPMENTS AND TRENDS IN THE SECONDARY MARKET 2-53 (1990-91 ed.). See also LORE, *supra* note 20, at 2-38. Banks and insurance companies have taken up some of the slack; one observer has reported that insurance companies presently hold approximately one-third of the mortgage-backed securities market. *IDD 1991 Figures*, *supra* note 4, at 22. See also Phil Roosevelt, *Banks Halt Their Binge in Mortgage Securities*, AM. BANKER, May 8, 1990, at 1; *Bank Profitability in the 1990's*, *supra* note 64, at 2/12. Banks and insurance companies also have been active in purchasing non-mortgage asset-backed securities. Although at first blush it may seem ironic that the sponsors of structured financings are among the most active purchasers, asset securitization may allow institutions to diversify their assets. Boemio and Edwards, *supra* note 56, at 663. For example, a Californian bank may find it desirable to securitize mortgages on properties on the West Coast and use the proceeds to buy CMOs backed by mortgages on East Coast properties.

<sup>73</sup>Boemio and Edwards, *supra* note 56, at 663; ROSENTHAL AND OCAMPO, *supra* note 2, at 13.

<sup>74</sup>In some cases, particularly for private placements, institutional investors are involved in structuring the financing.

<sup>75</sup>Wittebort, *supra* note 36, at 79 (according to Sears, "spreads over five-year Treasuries for credit card issues now run roughly 30 basis points below an index of single- and double-A corporate debt issues, versus about 40 basis points above the index in 1988..."). See also Boemio & Edwards, *supra* note 56, at 663.

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CMOs backed by agency securities have low risk weightings under depository institution capital requirements.<sup>76</sup>

In addition to the highly rated fixed income securities that are the predominant type of securities offered, many structured financings include other securities that are riskier such as stripped securities and residual interests. Some institutional investors find these securities attractive because they often have higher yields than the highly rated fixed income securities. In addition, institutional investors find that certain of these securities may be useful for hedging.<sup>77</sup>

## 2 The Retail Market

Although institutional investors are the predominant purchasers of structured financings, there is also a retail market in these securities. Some residential mortgage market products have been specifically targeted to retail investors. For example, since 1985, many CMOs and other multiclass mortgage-backed securities have been structured to include classes that are designed for the retail investor, with minimum denominations as low as \$1000.<sup>78</sup>

There are fewer retail transactions in the non-mortgage asset-backed market. In 1990, approximately \$1 billion of these securities were sold to individual investors, a seventy-six percent increase from 1989.<sup>79</sup> All were backed by credit card receivables originated by Sears Credit Account Trust or Standard Credit Card Trust.<sup>80</sup> Securities targeted for the retail market typically

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<sup>76</sup>See *supra* note 67.

<sup>77</sup>In 1990, banks and savings and loans became less active in purchasing some of these securities, possibly in anticipation of regulatory changes. See *Banks Halt Their Binge in Mortgage Securities*, *supra* note 72; *IDD 1991 Figures*, *supra* note 4, at 22. For further discussion of these securities and the proposed regulatory changes, see *infra* notes 132-138 and accompanying text.

<sup>78</sup>One observer has estimated that thus far, individual investors have accounted for approximately five percent of all REMIC sales. Richard Chang, *Promising Year for Mortgage Backeds*, *AM. BANKER*, Jan. 6, 1992, at 20.

<sup>79</sup>DEAN WITTER REYNOLDS, INC., **ASSET-BACKED SECURITIES REFERENCE GUIDE A-1**, (Jan.1991) [hereinafter DEAN WITTER].

<sup>80</sup>See DEAN WITTER, *supra* note 38, at A-18.

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have been rated AAA and sold in denominations as low as \$1000.<sup>81</sup> In 1991, no non-mortgage offerings were specifically targeted for retail investors.<sup>82</sup>

Retail investors find structured financing securities attractive because of their high ratings and because their yields are higher than those of comparable Treasuries<sup>83</sup> (although their yields usually are not as high as the yields on comparable structured financings sold on the institutional market).<sup>84</sup> Sponsors sell to retail investors to diversify and expand their investor base, as well as to ensure a liquid secondary market for their securities. Selling to the retail market is very labor intensive, however, and thus underwriting fees for structured financings directed to the retail market may be more expensive than for structured financings targeted for institutions.

### 3. The International Market

A significant number of structured financings sponsored by United States institutions are sold abroad. International issues have been structured both as unregistered Eurobonds in bearer form and as registered securities in the country or countries where the offering is sold. In addition, they have been sold overseas to both institutional and retail investors.

United States sponsors of structured financings have targeted the international market for a variety of reasons. Some have sold their issues overseas because their large portfolios need broad distribution. Others have gone overseas to avoid compliance with the Investment Company Act.

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<sup>81</sup>For example, "through its Dean Witter Reynolds subsidiary, [Sears] has sold \$1 billion in asset-backed securities to the retail market in denominations as low as \$1,000." Wittebort, *supra* note 36, at 79.

<sup>82</sup>DEAN WITTER, *supra* note 38, at A-18.

<sup>83</sup>In addition, one investment columnist has suggested that investors who desire more yield than that available from the average money market fund or certificate of deposit should investigate asset-backed securities. See James E. Lebherz, Asset-Backed Securities Can Be *Higher Yield* Investment, WASH. POST, June 30, 1991, at H9.

<sup>84</sup>DEAN WITTER, *supra* note 38, at A-18. For example, spreads on credit card asset-backed securities issued on the institutional market from January 1, 1989 to December 30, 1991, averaged approximately 83 basis points, while the spreads on similar asset-backed securities sold to retail investors averaged 46 basis points. Id.

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Although many offerings have been structured and sold directly in the international market, several sponsors have recently conducted "global" offerings, in which offerings are conducted simultaneously in the United States and abroad.<sup>85</sup> Global offerings provide a larger market for distribution and promote liquidity for sales on the secondary market.<sup>86</sup>

International investors find asset-backed securities attractive investments for many of the same reasons that domestic investors find them attractive. International investors, like domestic investors, are attracted to these securities, typically high ratings and view them as an alternative to corporate debt securities, which, in uncertain economic times, are less desirable investments.<sup>87</sup> Many international investors consider asset-backed securities "cheap investments" because they have higher yields than other, similarly rated debt<sup>88</sup>

Notwithstanding the fact that a significant number of United States sponsors are selling structured finance offerings abroad, international offerings have not been entirely successful. For many global offerings, a majority of the securities are ultimately placed in the United States.<sup>89</sup> Because structured financings are still in their infancy abroad, international investors must be educated as to the merits of these securities, particularly in light of their unfamiliar structure. This is particularly true for global offerings which must be

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<sup>85</sup>For example, 17 issues of non-mortgage asset-backed securities were sold in global offerings in 1991, more than double the number offered in all of 1990. DEAN WITTER, *supra* note 38, at A-1; DEAN WITTER, *supra* note 79, at A-1.

<sup>86</sup>In 1990, two Eurobond settlement agencies, Cedel S.A. and Euroclear System, began handling Citicorp-sponsored credit card structured financings, thereby linking international clearinghouse systems and permitting local clearance. See Michael R. Sesit, *Citicorp Forges "Global Bonds" with Credit-Card Link*, WALL ST. J., Aug. 30, 1990, at C1, C8.

<sup>87</sup>See Tracy Corrigan, *Asset-Backed Securities Make Their Mark on Europe*, FIN. TIMES, June 25, 1990, at I24.

<sup>88</sup>See Sesit, *supra* note 86, at C8.

<sup>89</sup>See, e.g., Tracy Corrigan, *Europe Grows Cautious of Credit Card-Backed Issues*, FIN. TIMES, June 21, 1990, at 22 (dealers report stronger demand in United States than in international markets for latest issues of bonds backed by credit-card receivables); Corrigan, *supra* note 87 ("asset-backed securities market remains substantially US-based, in terms of both issuers and investors"); *Citicorp Deal Well Received but Retail Holders Want Out*, THOMSON'S GLOBAL ASSET BACKED MONITOR, Aug. 31, 1990, at 1, 2. Foreign investors bought 48% and 45% respectively of Citicorp's first two global credit card offerings. See Sesit, *supra* note 86, at C8.

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structured to be attractive to both United States and foreign investors. For example, the limited European participation in one global offering was attributed in part to the fact that the payment schedule for the arrangement which, while typical for securities issued in the United States, was unfamiliar to European investors.<sup>90</sup>

#### D. Expectations for the Future

The future of structured financings is subject to some debate. Proponents have argued that this type of financing will become and remain in the long term as prevalent a financing technique as equity, conventional debt, or bank loans,<sup>91</sup> but others disagree.<sup>92</sup>

Most commenters, however, believe that, at least in the short term, structured financings will continue to have a large presence in the United States capital markets. One observer has predicted that 1992 will be a record-setting

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<sup>90</sup>The arrangement required coupons to be paid monthly, and the redemption of the principal to be spread out over the last year of the issue's life. See Tracy Corrigan, *MBNA America Bank in Asset-Backed Loan Debut*, FIN. TIMES, Nov. 2, 1990, at 130.

The difficulty in selling structured financings abroad is illustrated by the recent problems in the credit card backed securities market. Overseas issuances of financings backed by United States generated credit card receivables were virtually nonexistent in late 1990 and early 1991. This was due, in part to the rise in default rates on credit card receivables increasing the possibility of accelerated payments to investors, which caused anxiety among foreign investors that were unfamiliar with the concept of prepayment risk. As a result of this concern, sponsors have structured recent transactions to reduce the chance of prepayment. See Sears Taps International Bond Markets with \$750M of Card-Backed Securities, THOMSON'S GLOBAL ASSET BACKED MONITOR, Apr. 12, 1991, at 3; Patrick Harverson, Back to Normal After Scares over Prepayment Risk, FIN. TIMES; Jun. 19, 1991, at § III, p. III.

<sup>91</sup>See ROSENTHAL & OCAMPO, *supra* note 2, at 221-22; John B. Caolette, As the Capital Markets Unbundle What Will the Future Bring?, THOMSON'S GLOBAL ASSET BACKED MONITOR, Aug. 17, 1990, at 6; Wittebort, *supra* note 36, at 80. One observer has predicted that within the next 10 to 15 years, 60% to 80%, or more, of all new loans may be securitized. BRYAN, *supra* note 3, at 81.

<sup>92</sup>See, e.g., LeLogeais & Kerr, *supra* note 46. These observers argue that the need to securitize may not necessarily be as important in the future as it is today. They also assert that not all assets can be securitized because of their lack of uniformity, an assertion echoed by Rosenthal and Ocampo. Rosenthal and Ocampo acknowledge that some commenters believe that the recent growth of structured financings is only a "temporary exploitation of certain regulatory loopholes," although they conclude that securitization is not simply regulatory arbitrage. ROSENTHAL & OCAMPO, *supra* note 2, at 5.

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year for mortgage-backed securities, as low-interest rates prompt large increases in refinancings and initial loan originations.<sup>93</sup> The non-mortgage market also should remain strong to the extent that structured financings remain the best funding techniques for car companies and banks.<sup>94</sup>

In addition, some observers believe that more sponsors -- both financial and non-financial institutions -- will become interested in asset securitization. Such sponsors could seek to issue securities backed by assets that are not presently among those commonly being securitized.<sup>95</sup>

Finally, two federally sponsored entities have recently begun securitization programs. The Resolution Trust Company has begun to securitize more than seventy percent of the assets amassed from failed savings and loans.<sup>96</sup> Of the approximately \$67 billion in financial assets that will be used, \$57 billion are mortgage loans, \$3.2 billion are high yield bonds, and \$6.9 billion are consumer loans.<sup>97</sup>

In addition, in mid-1991, the Federal Agricultural Mortgage Corporation ("Farmer Mac"), which administers the secondary market activities for agricultural real estate loans, began issuing securities backed by pools of loans guaranteed by the Farmers Home Administration. In the near future, Farmer Mac intends to offer guarantees for securities backed by agricultural mortgages that are issued by conventional lenders.

### **III. The Securitization Process**

All structured financings share the same basic structure. We outline below the basic components of a typical structured financing and discuss how the

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<sup>93</sup>Chang, *supra* note 78.

<sup>94</sup>IDD 1991 Figures, *supra* note 4, at 23.

<sup>95</sup>For example, one observer predicted that financings backed by computer and other equipment leases would soon flourish. Wittebort, *supra* note 36, at 80.

<sup>96</sup>Susan Schmidt, *Cleanup Agency to Back Bonds With Thrift Assets*, WASH. POST, Oct. 25, 1990, at E1.

<sup>97</sup>*Id.* For additional discussion of the RTC securitization program, see Paulette Thomas, *S&L Liquidators Get \$294.5 Million in Junk Bond Sale*, WALL ST. J., Oct. 2, 1991, at B12; Paulette Thomas, *Mortgage-Backed 'Ritz' Maes' Stroll Down the Street with RTC*, WALL ST. J., Jul. 12, 1991, at C1.

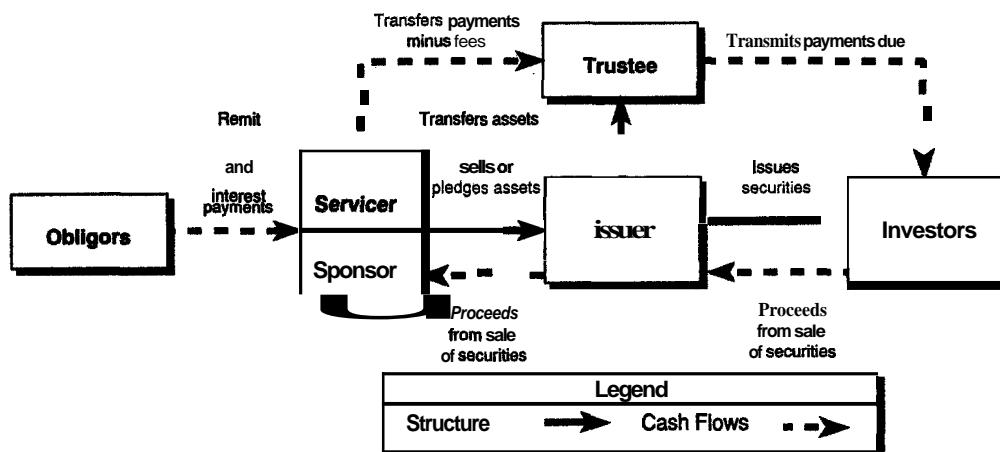
financing works. We also discuss investor protection issues, the role of the rating agencies, and the use of credit enhancement. Finally, we consider the differences between unrated and rated structured financings. Our discussion is necessarily general; there is a wide range of permutations used in practice.

## A. The Components of a Structured Financing

### 1. The Participants

A typical structured financing has four primary participants: **the sponsor**, who often is the initial owner of the assets; the issuer, who obtains the assets and issues the securities; the servicer, who takes ultimate responsibility for servicing the assets in the pool; and the trustee, who is assigned and holds the assets through the life of the issue and monitors the activities of the servicer.<sup>98</sup> The basic components of a structured financing are shown in Figure 1-5 below.

**FIGURE 1-5**  
**Structured Financing Components**



<sup>98</sup>Credit enhancers and the rating agencies may also participate in structuring the transaction. Because not all structured financings are rated or contain external credit enhancement, the roles and responsibilities of these parties are discussed separately. For a discussion of credit enhancement see Section III.B.2 *infra*. For a discussion of rating agencies, see Section III.B *infra*. Of course, as in most securities issuances, underwriters and independent auditors are also participants.

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A structured financing begins with a pooling and servicing agreement ("P&S agreement") among the sponsor, the trustee, and the servicer. The P&S agreement establishes the issuer and governs the transfer of the assets from the sponsor to the issuer (and ultimately to the trustee). It also sets forth the rights and responsibilities of the participants and typically contains a number of representations, warranties, and covenants about the characteristics of the assets. Finally, the agreement may require that periodic reports be sent to investors, the trustee, and other parties.

Typically, under the P&S agreement, the sponsor transfers a fixed pool of homogeneous assets, which it owns, to the issuer (either directly or through a subsidiary of the sponsor) in return for the proceeds from the sale of securities backed by these assets. In order for the sponsor to remove the assets from its balance sheet and therefore to obtain many of the benefits of asset securitization, the transfer must be a sale for accounting purposes.<sup>99</sup> Whether the transaction

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<sup>99</sup>Under generally accepted accounting principles ("GAAP"), a sale occurs when both the risks and rewards of ownership have been transferred to the purchaser. Under GAAP, a sponsor may remove assets from its balance sheet if the sponsor sells the assets without recourse. For many sponsors, a transfer with recourse may still be a sale, provided that the transfer meets the conditions set forth in Statement of Financial Accounting Standards No. 77 ("FAS 77"). FAS 77 generally provides that a transfer of receivables with recourse shall be recognized as a sale if (i) the transferor surrenders control of future economic benefits of the sold receivables, (ii) the transferor cannot be required by the transferee or any other entity to repurchase the receivables except in accordance with the recourse provisions, and (iii) the transferor's recourse obligation can be reasonably estimated. FAS 77 is currently under review as part of a re-examination of financial instruments and off-balance sheet accounting.

Historically, banks and savings and loans have generally been subject to regulatory accounting principles (**"RAP"**). RAP, like GAAP, has allowed a sponsor to remove assets from its balance sheet if the sponsor sells the assets without recourse. Unlike GAAP, however, RAP generally has required an asset sale with recourse to be treated as a borrowing. The seller must continue to hold the full amount of regulatory capital reserves against the proceeds from the transfer of the assets. There are two relevant exceptions. First, in regard to sales of participations in pools of residential mortgages, the bank may treat the transfer as a sale as long as the bank does not retain any "significant risk of loss," which generally has been viewed as being more than 10% recourse. The other exception pertains to the use of "spread accounts," which are also a type of credit enhancement, discussed *infra* note 232 and accompanying text. For more information about the accounting aspects of securitization, see Ernest L. Puschaver, *Accounting Issues, in 2 SECURITIZATION OF FINANCIAL ASSETS*, *supra* note 21, at §§ 18.01-18.04; ROSENTHAL & OCAMPO, *supra* note 2, at 65-73; PAVEL, *supra* note 43, at 163-181 (Chapter 7, "Accounting for Securitization: GAAP versus **RAP**").

Recently, section 121 of the Federal Deposit Insurance Corporation Improvement Act of 1991  
(continued...)

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between the sponsor and the issuer constitutes a sale also is relevant to determining whether the assets transferred and the cash flow therefrom could be used to pay the sponsor's creditors should the sponsor become insolvent. (What constitutes a sale for bankruptcy purposes may differ from what constitutes a sale for accounting purposes.)

The issuer is typically a special purpose entity whose only business activity is to acquire and hold the assets, and issue securities backed by the assets. Because the issuer has no significant facilities or employees, its duties are contracted out to other parties, primarily the servicer.<sup>100</sup>

The form of organization of the issuer generally depends on tax considerations and the desired payment structure of the financing.<sup>99</sup> There are two basic types of payment structures that are used: pass-through and pay-through.<sup>102</sup> In a pass-through structure, the issuer typically is a grantor trust.<sup>103</sup> A grantor trust essentially is a trust that acts as a conduit for the

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<sup>99</sup>(...continued)

(Pub. L. **102-242**, **105** Stat. **2236**, **2250-51** (Dec. **19**, 1991), codified at **12 U.S.C. § 1831n**) amended the Federal Deposit Insurance Act to require that financial statements submitted to federal banking agencies be prepared in accordance with GAAP, unless an agency determines that a particular GAAP principle is inconsistent with certain stated objectives, in which case the agency may prescribe **an** accounting principle no less stringent than GAAP.

<sup>100</sup>2 FRANKEL, *supra* note 3, § **14.1**, at **80-81**; *The Importance of the Role of the Servicer in Securitized Transactions*, MOODY'S STRUCTURED FINANCE RESEARCH & COMMENTARY, Apr. **1990**, at **12** [hereinafter *The Servicer in Securitized Transactions*].

<sup>99</sup>The form of organization of an issuer holding mortgagelated assets need not affect the payment structure of the financing if the issuer elects REMIC status. See *infra* note **149** and accompanying text.

<sup>102</sup>For a general discussion of these structures and the attendant tax issues, see, e.g., William A. Schmalz et al., *Tax Issues*, in **1 SECURITIZATION OF FINANCIAL ASSETS**, *supra* note 21, §§ **9.01-9.06**; Charles M. Adelman & Roger D. Lorence, *Tax Considerations*, THE ASSET SECURITIZATION HANDBOOK, *supra* note **46**, at **298-334**; ROSENTHAL & OCAMPO, *supra* note 2, at **48-63**.

<sup>103</sup>ROSENTHAL & OCAMPO, *supra* note 2, at **49**. Although securitizations of credit card receivables use trusts that issue certificates and often are characterized as pass-through (see DEAN WITTER, *supra* note 38, at **B-37** to **B-43** (characterizing Sears Credit Card Account Trusts as pass-through)), the structure of this type of financing generally prevents the issuer from qualifying as a grantor trust for tax purposes. See Jason H.P. Kravitt, *A Brief Summary of Structures Utilized in the Securitization of Financial Assets*, in **1 SECURITIZATION OF FINANCIAL ASSETS**, *supra* note 21, § **4.03[C]**, at **4-39**.

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outright sale of assets to the investors. Investors purchase certificates representing a fractional undivided interest in the trust and are entitled to a pro rata share of the cash flows from the assets.<sup>104</sup> To be considered a grantor trust for tax purposes, the trust must be passive. Thus, this structure generally requires that the pool remain fixed, except for limited substitutions to replace "defective" assets, and does not allow for management of cash flows.<sup>105</sup>

In a pay-through structure, the issuer typically is a special purpose corporation or an owner trust.<sup>106</sup> Most of the securities issued are structured as debt, permitting deduction of interest payments which offsets the income received on the assets. Issuers structured in this manner need not be subject to the constraints imposed by the grantor trust tax classification. Thus, payments to investors need not be tied to the incoming cash flows from the underlying assets, but rather may be structured to permit the creation of classes of securities with different payment schedules that are tailored to investor demand.<sup>107</sup>

The servicer is the primary administrator of the financing. Often the sponsor or an affiliate of the sponsor is the servicer.<sup>108</sup> In other financings, the

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<sup>104</sup>The certificates are considered to be equity (1 FRANKEL, *supra* note 3, § 8.2, at 289), although in many respects they have debt-like characteristics. One drawback of these securities, from a marketing standpoint, is that investors are subject to greater prepayment risk. ROSENTHAL & OCAMPO, *supra* note 2, at 53. For a discussion of the characteristics of these securities, see *infra* note 128 and accompanying text.

<sup>105</sup>The trust must be passive to avoid being classified as an association, which would be taxable as a corporation. Such a characterization could have adverse tax consequences because the interest income to the trust from the assets would be taxable while the payments from the trust to the investors would be nondeductible distributions. Consequently, the trust would have a substantial tax liability, and investors would receive yields substantially less than anticipated. ROSENTHAL & OCAMPO, *supra* note 2, at 51.

<sup>106</sup>*Id.* at 54.

<sup>107</sup>*Id.* at 55.

<sup>108</sup>See *Credit Curd Deals Aren't Equal*, FITCH STRUCTURED FINANCE (Special Report), Apr. 10, 1990, at 5. If the sponsor is the servicer, the sponsor typically agrees that, in servicing the accounts, it will impose the same terms as those it imposes with respect to its own portfolio of accounts. In some mortgage transactions, where the sponsor is a conduit, each originator of the mortgages in the pool may act as a "subservicer," and perform many of the functions that the servicer would perform, but only for the mortgages it originates. A "master servicer" is responsible for overseeing the subservicers and tracking the funds from subservicers to investors. See STANDARD & POOR'S CORPORATION, S&P'S STRUCTURED FINANCE CRITERIA 98 (1988)[hereinafter S&P'S STRUCTURED FINANCE CRITERIA].

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servicing function is carried out by a third party that may not necessarily be in the business of generating the type of assets that it is servicing.

The servicer collects payments on the underlying assets when due and ensures that funds are available so that investors are paid in a timely manner.<sup>109</sup> The servicer's specific obligations depend on the transaction and the assets involved. Generally, the servicer is responsible for collecting on delinquent accounts.<sup>110</sup> The servicer may commingle collections on the assets with its own funds until payment to investors, may remit the collections to the trustee, or maintain the funds in custodial accounts.<sup>111</sup> The servicer may also reinvest idle cash in short-term investments when there is a timing mismatch between the collections and distributions to investors.<sup>112</sup>

In addition, the servicer oversees the substitution of assets as permitted by the P&S agreement. For example, the agreement may permit the substitution of assets that are determined not to meet specified eligibility criteria. A servicer also may monitor tax and insurance payments, maintain escrow accounts, advance funds to provide liquidity to cover loans in arrears, maintain all relevant documentation, and administer other day-to-day operations of the issuer.<sup>113</sup>

The trustee is appointed to monitor the issuer's obligation to investors. Generally, publicly issued structured financings that issue debt are subject to the Trust Indenture Act.<sup>114</sup> The Trust Indenture Act sets forth requirements

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<sup>109</sup>See 2 FRANKEL, *supra* note 3, § 14.8, at 91.

<sup>110</sup>*Id.*

<sup>111</sup>If the credit quality of the servicer is low, some risk is created by the servicer commingling collections. The funds may become subject to claims of the servicer's creditors if the servicer becomes insolvent. See Darrow, et al., *supra* note 21, § 7.02[D][2], at 7-14.

<sup>112</sup>*Id.* at 7-13.

<sup>113</sup>See S&P'S STRUCTURED FINANCE CRITERIA, *supra* note 108, at 24.

<sup>114</sup>Congress amended the Trust Indenture Act in 1990. See Trust Indenture Reform Act of 1990, Pub. L. 101-550, 104 Stat. 2721 (1990), codified at 15 U.S.C. §§ 77ccc-77eee, 77iii-77rrr, and 77vvv (effective November 15, 1990). The 1990 legislation, among other things, removed the prohibition against an otherwise qualified trustee that has one of the statutorily specified relationships with the obligor on the indentured securities (formerly "conflicts of interest") from serving as trustee provided that there is no default. The legislation also expressly incorporated provisions previously required to be specifically placed in the trust indenture, and gave the Commission exemptive authority.

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regarding, among other things, the eligibility and qualifications of trustees,<sup>115</sup> the preferential collection of claims against the issuer, and reporting obligations. The Trust Indenture Act also addresses the duties of trustees when an issuer defaults.

The Trust Indenture Act applies only to financings that issue debt. Because pass-through certificates are regarded as equity, transactions issuing such securities are not subject to that Act. As a practical matter, however, the structures of many such transactions are similar to transactions that are subject to the Trust Indenture Act.<sup>116</sup> Similarly, although private placements are exempt from the Trust Indenture Act, some of these transactions also are structured in a way that is consistent with that Act's requirements.

In a publicly offered structured financing, the trustee typically is a bank that is not affiliated with the sponsor or any other parties to the transaction.<sup>117</sup> only a few entities currently are in the business of acting as trustees in structured financings.

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<sup>115</sup>Generally, the Trust Indenture Act requires the appointment of one or more trustees, at least one of which is a corporation organized under the laws of the United States or a state (or organized under the laws of a foreign government as permitted by the Commission), with a minimum combined capital and surplus of \$150,000. 15 U.S.C. § 77jjj (a) (1)& (2). The Trust Indenture Act prohibits an obligor or its affiliate from serving as trustee for indentured securities offered by the obligor. 15 U.S.C. § 77jjj(a)(5). Also, if a trustee has or becomes subject to a conflicting interest, the trustee must resign or remove the conflict. 15 U.S.C. § 77jjj(b). A conflicting interest generally arises if the indentured securities are in default and the trustee has one of the relationships with the obligor set forth in section 310(b) of the Trust Indenture Act. 15 U.S.C. § 77jjj(b).

<sup>116</sup>See LORE, *supra* note 20, at 4-49.

<sup>117</sup>Because the Trust Indenture Act prohibits the obligor or its affiliates from serving as trustee, neither a sponsor of a structured financing that falls within that Act, its affiliates, nor a credit enhancer (which meets the definition of obligor under Section 303(12) of that Act) may act as trustee. The Trust Indenture Reform Act of 1990, *supra* note 114, amended the Trust Indenture Act to provide that an underwriter may act as trustee so long as there is no default. See 15 U.S.C. § 77jjj(b)(2).

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Generally, the trustee is assigned and holds the underlying assets (or documentation of interest in the assets) in accounts designated for each structured financing for the benefit of investors. The trustee also receives payments from the servicer and any credit enhancers, and remits them to investors.<sup>118</sup> The trustee also may reinvest the funds on a short-term basis prior to payment."<sup>119</sup> In addition, the trustee reviews the activities of the servicer, in part by receiving periodic reports from the servicer on payments and future projections. The trustee may be expected to calculate the payments and future cash flow projections if the servicer fails to perform this duty.<sup>120</sup> Similarly, if the servicer becomes insolvent or withdraws, the trustee may act as interim servicer until another servicer has been appointed. Finally, the trustee may act to represent the interests of investors if there is a default.<sup>121</sup>

## 2. The Securities Issued

Almost all issuers, whether using a pass-through or pay-through structure, offer fixed-income securities (*i.e.*, securities that are either debt obligations or that have debt-like characteristics).<sup>122</sup> The securities typically entitle the holder or owner to a specified principal amount at maturity and bear interest based on the principal amount at a fixed rate, a floating rate determined periodically by reference to an index, or a rate determined through periodic auctions among investors or prospective investors, or through the periodic remarketing of the instrument.<sup>123</sup> The interest rate also may be determined by reference to

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<sup>118</sup>Asset Finance Group, The First Boston Corp., *Overview of Assets and Structures*, in THE ASSET SECURITIZATION HANDBOOK, *supra* note 46, at 35-36.

<sup>119</sup>E. Kay Liederman, *The Role of the Trustee in Securitization*, AM. BANKER (Special Adv. Supp.), Dec. 17, 1991, at 13A.

<sup>120</sup>See S&P's STRUCTURED FINANCE CRITERIA, *supra* note 108, at 24.

<sup>121</sup>For a more detailed discussion of the role of the trustee, see Liederman, *supra* note 119.

<sup>122</sup>The traditional distinction between debt and equity is somewhat blurred in the context of structured finance. For further discussion, see 1 FRANKEL, *supra* note 3, § 8.9 at 301.

<sup>123</sup>A few issuers, mainly finance subsidiaries of thrift institutions and corporations, have offered asset-backed auction rate preferred stock. See S&P's STRUCTURED FINANCE CRITERIA, *supra* note 108, at 51. See also 1 FRANKEL, *supra* note 3, § 8.6.

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specified portions of the interest received on the underlying assets. The average life of most non-mortgage structured financings ranges from one to five years; mortgage-backed securities usually have a longer duration.<sup>124</sup> The securities are not redeemable at the option of the holder.

The payment of the security derives directly from the cash flow generated by the portfolio of assets.<sup>125</sup> The yields paid to investors obviously must be lower than the effective yield on the underlying assets. For example, securities backed by credit card receivables may yield only nine percent, even though the receivables themselves yield eighteen percent.<sup>126</sup> Investors, in effect, give up a substantial portion of the yield spread because the transformation of these assets into securities enables investors to receive what they consider to be safer and more liquid investments than if they had purchased the assets without the financing being structured.<sup>127</sup>

The structure of the security depends in part on whether the payment structure is pass-through or pay-through. In the case of a pass-through structure, with two exceptions discussed below, the issuer must issue a single class of securities. Each security represents a fractional interest in the trust. Investors are entitled to a pro rata share of the cash flows, net of fees. This structure requires that all payments, including prepayments, be passed through to investors almost immediately after receipt. Accordingly, the timing of payments and maturity of

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<sup>124</sup>The average life of a debt security is the expected average time it will take to repay each dollar of principal. Most securities backed by automobile loans, for example, run from one to two years, while credit card-backed securities typically have a maturity of two to six years. DEAN WITTER, *supra* note 38, at A-28.

<sup>125</sup>There are two other payment structures used in structured finance for which payment does not depend directly on the cash flow on the assets. "Market value transactions" are financings in which payment on the securities sold depends on the market value of the underlying assets. This structure has been used primarily in securitizing high yield bonds. See *infra* note 162. "Third party credit-supported debt" involves the issuance of securities the payment on which is derived primarily from third-party credit support. Darrow et al., *supra* note 21, § 7.02[B], at 7-9. Because the overwhelming majority of structured financings are cash flow transactions, these other payment structures generally are not discussed in this chapter.

<sup>126</sup>The differential usually is used to pay fees for servicing and credit enhancement and to cover losses on the underlying assets. Any remaining spread may be allocated to the holder of the residual interest. See *infra* notes 143-145 and accompanying text.

<sup>127</sup>See BRYAN, *supra* note 3, at 81-82.

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a pass-through security is uncertain, and investors may receive payment of principal when reinvestment opportunities are relatively unattractive.<sup>128</sup>

In contrast, the pay-through structure allows allocation of cash flow to permit the issuance of securities with maturities and payment schedules different from those of the underlying assets. Although structured financings using the pay-through structure may issue only one class of securities, many issue several classes. One common form of this structure, often called the "sequential-pay structure," permits the issuance of several classes of securities with differing maturities. Typically, interest is paid concurrently on most or all of the classes, but principal is allocated to one class until that class is retired. The other classes are retired sequentially in order of maturity date.<sup>129</sup> Yields and ratings may vary among the classes. In addition, the pay-through structure permits the use of different payment schedules. Thus, the pay-through structure permits securities to be structured with maturities and payment schedules that meet the needs of particular investors.<sup>130</sup>

Both structures permit the issuance of stripped securities. Stripped securities are created by splitting the cash flow from an asset pool into separate components of interest and principal, so that investors of different classes receive unequal proportions of principal and interest. There are an infinite number of possible principal and interest combinations. In simplest form, strips are issued in interest only ("IO") and principal only ("PO") classes. IO certificates entitle the holder to a pro rata share of interest paid on the assets, without any preference or priority in the class. PO certificates entitle the holder to a pro rata share of principal payments made on the assets. Stripped securities were developed for and are used primarily in the mortgage market.<sup>131</sup>

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<sup>128</sup>See, e.g., ROSENTHAL & OCAMPO, *supra* note 2, at 52-54; CRAIG J. GOLDBERG, MERRILL LYNCH MORTGAGE CAPITAL INC., *INVESTING IN ASSET-BACKED SECURITIES* 9-10 (1988).

<sup>129</sup>A multiclass structure may contain classes that issue more complicated types of securities, such as zero coupon and floating rate bonds and stripped securities. See, e.g., Pittman, *supra* note 15, at 506-507; Rating Whole-Loan Backed Multiclass Securities, MOODY'S STRUCTURED FINANCE RESEARCH & COMMENTARY, Aug. 1989, at 12.

<sup>130</sup>See GOLDBERG, *supra* note 128, at 9-10. See also *supra* text accompanying note 107.

<sup>131</sup>See, e.g., Pittman, *supra* note 15, at 511. When we refer to "stripped securities," we are excluding stripped Treasury Securities where principal and interest components of Treasury notes and bonds are separated.

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IO and PO certificates are volatile securities. The investor in an IO or PO certificate is paying for an interest in a payment stream that is priced based upon an assumed prepayment pattern. Accordingly, changes in interest rates or other factors that alter prepayments on the assets greatly affect the timing and amount of payment on the securities and thus the value of the securities.<sup>132</sup>

Despite this volatility, or because of it, many institutional investors have purchased stripped securities either as stand alone securities or for use as hedging devices.<sup>133</sup> Because of the risks inherent in investing in stripped securities and similar instruments, the Federal Financial Institutions Examination Council ("FFIEC")<sup>134</sup> has issued for comment a Supervisory Policy Statement concerning the selection of securities dealers by, and certain securities activities of, depository institutions.<sup>135</sup>

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<sup>132</sup>*Id.* at 511-512. If the assets are prepaid faster than expected (e.g., when interest rates decline), IO investors may suffer large losses. In the case of a sudden drop in interest rates, IO investors may lose most of their investment. PO investors would experience a gain in this situation since PO certificates are sold at discount and investors would recover their investment sooner than anticipated. Conversely, if the assets are prepaid more slowly than expected (e.g., when interest rates are rising), IO investors benefit because maturities lengthen and more interest is collected. PO investors effectively would experience a loss because the yield to maturity on the certificates would be lower since the term to maturity of the assets is extended. *Id.*

<sup>133</sup>The credit quality of stripped securities may be rated. The ratings, however, do not address prepayment risk. See *Stripped Mortgage Securities*, STANDARD & POORS CREDITVIEW: COLLATERALIZED MORTGAGE OBLIGATIONS, Aug. 29, 1988, at 5.

<sup>134</sup>The FFIEC consists of the Board of Governors of the Federal Reserve System, the FDIC, the Office of the Comptroller of the Currency, the Office of Thrift Supervision, and the National Credit Union Administration.

<sup>135</sup>In January 1991, the FFIEC published for comment Supervisory Policy Statement Concerning Selection of Securities Dealers, Securities Portfolio Policies and Strategies and Unsuitable Investment Practices, and Stripped Mortgage-Backed Securities, Certain CMO Tranches, Residuals, and Zero-Coupon Bonds, 56 FR 263 (Jan. 3, 1991). In response to comments, in August, 1991, the FFIEC published for comment a revised portion of the Supervisory Policy Statement that pertained to the acquisition of stripped mortgage-backed securities, certain CMO tranches, residual interests, and zero coupon bonds. Supervisory Policy Statement on Securities Activities, 56 FR 37095 (Aug. 2, 1991) [hereinafter Supervisory Policy Statement].

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Under the proposal, stripped securities and certain other securities that the FFIEC considers to be "high-risk mortgage securities"<sup>136</sup> are deemed to be "[un]suitable investments for depository institutions" because of their volatility. Accordingly, the proposal would prohibit most depository institutions from investing in such securities unless they are purchased for the purpose of reducing the institution's overall interest rate risk.<sup>137</sup> Depository institutions wanting to purchase these securities must have the internal ability to determine both prior and subsequent to purchase that the securities would actually reduce interest rate risk. Depository institutions would be required to dispose of high-risk mortgage securities that do not reduce interest rate risk in an orderly fashion.<sup>138</sup>

In addition, both pass-through and pay-through structures permit the issuance of classes of senior and subordinate securities. The senior/subordinate structure splits the cash flow into at least two classes. The senior class has first claim on the cash flow from the pool; the subordinate class absorbs credit losses before the senior class.<sup>139</sup>

The senior class usually is offered publicly and is considered to be insulated from credit risk in part because of the presence of the subordinated class. Performance of the classes depends on the specific senior/subordinate structure adopted and on the actual level of defaults on the assets. The

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<sup>136</sup>In general, the FFIEC considers any mortgage derivative product that possesses average price volatility or average life greater than a standard, fixed-rate 30-year mortgage-backed pass-through security to be "high risk." Thus, the policy also applies to certain CMOs, certain REMICs, and CMO and REMIC residuals. Supervisory Policy Statement, *supra* note 135, at 37096-98. In addition, the policy applies to residuals issued in non-mortgage structured financings. *Id.* at 37097. For a discussion of residuals, see *infra* notes 143-145 and accompanying text. The National Association of Insurance Commissioners is drafting a proposal limiting insurance company purchases of these securities. *See IDD 1991 Figures, supra* note 4, at 22.

<sup>137</sup>Depository institutions with "strong capital and earnings and adequate liquidity" and with "closely supervised trading department[s]" would be permitted to purchase high-risk mortgage securities for trading purposes. *See Supervisory Policy Statement, supra* note 135, at 37096 n.1.

<sup>138</sup>*Id.* at 37098. The proposal would also require that the depository institutions develop written portfolio policies, approved by their boards, regarding the purchase of these types of securities. *Id.*

<sup>139</sup>Some senior/subordinate structures split the cash flows into several senior sequential-pay classes. Similarly, some structured financings have more than one subordinated class. *See Rating Whole-Loan Backed Multiclass Securities, supra* note 129, at 11-12.

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subordinate class may be privately placed, publicly offered,<sup>140</sup> with yields higher than those of the senior class certificates,<sup>141</sup> or held by the sponsor.<sup>142</sup>

Finally, most structured financings include residual interests, which are equity interests backed by cash flow not needed to pay the holders of the fixed-income securities or to pay administrative expenses. This cash flow may be derived from income generated by the reinvestment of collections on the assets prior to disbursement to investors, by overcollateralization, or by the spread between the interest rate on the assets and the interest rate on the fixed-income securities.<sup>143</sup>

Residuals may have a high return, but they are volatile, unpredictable securities. Predicting the ultimate return on residual interests is highly complicated, and requires a high degree of sophistication, given the variety of sources of cash flows and the effects of changes in prepayments and interest rates on the cash flow. The risks vary from transaction to transaction, depending on the transaction's structure and assets. The interdependency of these factors "leads to myriad analyses and predictions for residual interest investors."<sup>144</sup>

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<sup>140</sup>The market for subordinate securities has grown tremendously in the last two years, with estimated issuance for **1991** totaling over \$2 billion. Wesley W. Sparks, *The Consumer Asset-Backed Market: A Trader's Perspective*, *AM. BANKER* (Special Adv. Supp), Dec. 17, **1991**, at 1A, 6A.

<sup>141</sup>The subordinate class may or may not be rated. GOLDBERG, *supra* note **128**, at **12**. If the subordinate class is rated, it usually has a rating lower than the senior piece. In many cases, the subordinate class has an external credit enhancement and is thereby protected to some degree against default losses. The amount of credit enhancement needed to achieve an investment grade rating is relatively **high** due to the greater risk of default. See *Credit Card Deals Aren't Equal*, *supra* note **108**, at 13.

<sup>142</sup>The sponsor's retention of the subordinated class is considered by some to be a form of recourse, and therefore the transfer of the receivables to the pool may not be considered a true sale for bankruptcy concerns. For example, following a downgrade of the rating of Sears' senior debt, Fitch downgraded from AAA to AA certain structured financings where Sears retained the subordinate class. See *Sears' Debt, Asset-Backed Ratings Cut*, FITCH INSIGHTS, Apr. 16, **1990**, at 4.

<sup>143</sup>See, e.g., Pittman, *supra* note **15**, at **509-510**; Boemio & Edwards, Jr., *supra* note **56**, at 662.

<sup>144</sup>CMO Residuals, STANDARD & POOR'S CREDIT REVIEW: COLLATERALIZED MORTGAGE OBLIGATIONS, Aug. **29**, **1988**, at **4**. Residuals structured as equity are not rated. Some residuals are structured as debt, having stated principal amounts (which often are extremely small) and bearing interest at a minimum stated rate. These securities can be rated. As with other debt-like obligations, the rating does not address prepayment and interest rate risk, which can be extreme for residuals.

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Initially, residual interests usually were retained by the sponsor. In the last several years, residual interests increasingly have been sold to institutional investors, which usually purchase them for hedging purposes.<sup>145</sup>

### **3. Types of Structured Financings**

Many structured financings, regardless of their underlying assets, are structured and operate generally in the manner set forth in the previous two subsections. Some structured financings, however, possess different attributes than other types of structured financings, in part because of the nature of their assets. This section briefly describes some of these differences.

#### **a. CMOs and REMICs**

CMOs are multiclass, sequential pay, debt obligations backed by various types of mortgage loans or by mortgage-backed securities.<sup>146</sup> Most CMOs issue at least four tranches, with each tranche typically having a different maturity, interest rate, and prepayment risk. Like most sequential pay securities, the first tranche on which principal is paid typically is the class with the shortest maturity.

That class generally bears the highest prepayment risk, while classes with longer maturities bear less of a prepayment risk. To reduce prepayment risk, CMOs may contain tranches that issue "planned amortization class" bonds ("PACs"). Investors in PACs receive principal and interest payments that are made in accordance with a fixed amortization schedule that does not depend on the rate of prepayments of the underlying mortgages, thereby providing a high degree of predictability regarding final maturity and expected average life. Prepayment risk is shifted to other tranches in the CMO, which consist of "companion" bonds that are subordinate to PACs and which have more volatile prices and expected average lives. Some CMOs also include tranches that issue stripped securities, zero coupon bonds, floating rate bonds, and debt-like residual securities.

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<sup>145</sup>See 1 FRANKEL, *supra* note 3, § 8.3.2.

<sup>146</sup>Of the approximately \$118.6 billion in CMOs and other multiclass mortgage securities offered in 1990, approximately \$112.8 billion or ninety-five percent held pass-through securities as collateral. *Database*, *supra* note 16, at Table 3. Of the approximately \$138.0 billion in CMOs and other multiclass mortgage-backed securities offered in the first three quarters of 1991, approximately \$134.8 billion or 97.7%, held pass-through securities as collateral. *Id.*

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Many issuers elect to be treated as "real estate mortgage investment conduits" ("REMICs"), which were created by the Tax Reform Act of 1986.<sup>147</sup> The election of REMIC status permits the issuance of multiple classes of securities without tax constraints.<sup>148</sup> REMIC status affects only the taxation of the issuer and the investors -- the securities law and accounting requirements remain the same.

Under the REMIC provisions, the issuer's form of organization does not affect the payment structure. The issuer may be a grantor trust, corporation, partnership, or even a designated pool of mortgages that is not a separate legal entity. The securities issued may be pass-through securities, debt, stock, or partnership interests. Only issuers of securitized mortgage products can elect REMIC status.<sup>149</sup>

In practice, REMICs are very similar to CMOs (and are considered by some to be a subset of CMOs), with the exception of their tax treatment. A REMIC must issue at least two types of securities: regular interests and residual interests. A REMIC may have multiple classes of regular interests, each with varying maturities, but only one class of residual interests.<sup>150</sup> Although REMIC status is elective, as of January 1, 1992, it is generally the only means for issuing

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<sup>147</sup>Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2309, Title VI, § 671(a)(Oct. 22, 1986), codified and amended as 26 U.S.C. §§ 860A-860G.

<sup>148</sup>For example, non-REMIC multiclass securities generally must be issued as debt obligations to avoid dual taxation. See *supu* notes 106-107 and accompanying text.

<sup>149</sup>See Kravitt, *supu* note 103, § 4.02[c], at 4-16. Substantially all of the assets of a REMIC must consist of "qualified mortgages" or "permitted investments." I.R.C. § 860D(a)(4). The term "qualified mortgage" includes "any obligation (including any participation or certificate of beneficial ownership therein) which is principally secured by an interest in real property," among other things (I.R.C. § 860G(a)(3)), such as residential and commercial mortgages and mortgage-backed securities. The term "permitted investment" includes any cash flow investment, qualified reserve asset, or foreclosure property. I.R.C. § 860G(a)(5).

<sup>150</sup>For tax purposes, regular interests are considered debt, notwithstanding the actual form of ownership interest, while residual interest holders are treated much like partners in a partnership. Residual interest holders do not, however, have the disadvantages associated with owning a partnership interest, *i.e.*, the limited ability to transfer the interest, and personal liability. See ROSENTHAL & OCAMPO, *supra* note 2, at 60-62; Pittman, *supra* note 15, at 508-09.

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multiclass mortgage-backed securities without certain adverse tax consequences.<sup>151</sup>

### **b. Revolving Accounts Receivable**

Many of the assets being securitized are fixed payment obligations; that is, they are loans for a fixed amount of credit, amortized according to a fixed schedule of payments. Such assets include fixed rate residential mortgages, consumer automobile loans, boat loans, and manufactured housing loans.

Revolving accounts receivable also are being securitized, however. A revolving account generally allows a borrower to draw on a line of credit up to a certain limit and repay only a minimum amount on a monthly basis. A borrower may pay more than the minimum monthly amount or repay the entire outstanding balance when billed. Thus, unlike a fixed payment obligation, the outstanding balance in a revolving account is unpredictable and may vary significantly every month. The type of revolving account most commonly securitized is the credit card account receivable.<sup>152</sup>

The structure of a financing backed by credit card accounts receivable reflects the characteristics of the asset. Typically, the sponsor pools and transfers to a trust current and future receivables generated by specified credit card accounts. The accounts themselves do not become the property of the trust. Although the portfolio of the accounts from which the receivables are generated is fixed at the time the securities are issued, the balance of the pooled assets will fluctuate as new receivables are generated and existing amounts are paid or charged off as a default. Although credit card balances fluctuate, the balance of a large pool of credit card receivables is generally predictable over time, which permits credit card receivables to be securitized.<sup>153</sup> In the event that the

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<sup>151</sup>See Kravitt, *supra* note 103, § 4.02[C], at 4-16, and Robert E. Gordon, et al., *Real Estate, in 2 SECURITIZATION OF FINANCIAL ASSETS*, *supra* note 21, § 15.02[E][2], at 15-39 to 15-40.

<sup>152</sup>Revolving home equity lines of credit and revolving wholesale automobile loans also are beginning to be securitized. For a discussion of the securitization of home equity loans, see *Securitizing a New Industry*, STANDARD & POOR'S CREDIT REVIEW: ASSET-BACKED SECURITIZATION, Mar. 27, 1989, at 49-54.

<sup>153</sup>See *Credit Card Deals Aren't Equal*, *supra* note 108, at 7.

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accounts do not generate enough receivables to support the securities, the sponsor may be required to assign receivables from other accounts to the pool.<sup>154</sup>

In most cases, to accommodate the fluctuating balances, at least two classes of certificates are issued: the investor certificates and the seller (sponsor) certificates. The interests of these securities typically are equal in priority (*i.e.*, "*paripassu*"). The outstanding principal amount of the seller's certificate, however, will fluctuate to absorb variations in the balance of the pool, thereby enabling the principal balance of the investors' certificates to be maintained at a fixed level for a stated term.<sup>155</sup> The investor certificates, which represent most of the interests in a pool (typically eighty percent or more), are usually sold in a public offering. The remaining interest is allocated to the seller's certificate, and is retained by the seller.

A credit card portfolio typically liquidates at a rapid rate (eight percent to twenty percent per month). Thus, the expected life of a credit card portfolio is less than one year, assuming a constant portfolio size.<sup>156</sup> To extend the life of the securities, investors are paid only interest during the transaction's initial stages, typically eighteen to thirty-six months. During this period, principal payments are allocated to the sponsor and used to purchase additional receivables arising from the pooled accounts. The "interest-only" period (also called the "non-amortization" or "revolving period") is followed by an "amortization" period in which investors receive distributions of principal in accordance with a specified payment schedule.<sup>157</sup> The basic components of a financing backed by credit card accounts receivable are illustrated in Figure 1-6 below.

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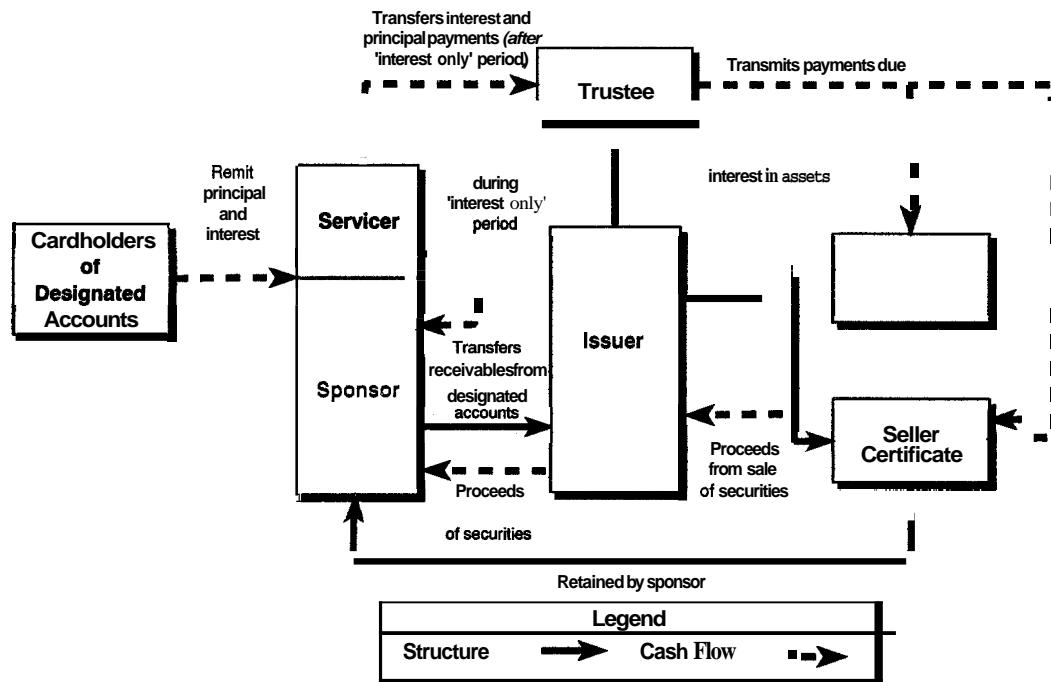
<sup>154</sup>*Id.* at 15.

<sup>155</sup>See *id. at 7*; *Credit Card-Bucked Securities' Innovations*, STANDARD & POOR'S CREDIT REVIEW: ASSET-BACKED SECURITIZATION, Sept. 12, 1988, at 34.

<sup>156</sup>See *Credit Card-Bucked Securities Innovations*, *supra note 155*, at 34.

<sup>157</sup>Several amortization methods have been used to make the schedule of principal distributions more predictable. For more information on these methods, see *Credit-Curd-Bucked Securities: Understanding the Risks*, MOODY'S STRUCTURED FINANCE RESEARCH & COMMENTARY (Special Report), Jan. 1991, at 18-19; *Credit Curd Deals Aren't Equal*, *supra note 108*, at 8-12.

**FIGURE 1-6**  
**Financing Backed by Credit Card Accounts Receivable**



Unlike most other assets used in structured financings, pooled credit card accounts receivable return to the balance sheet when the securities are retired. To continue to keep these assets off the sponsor's balance sheet new financings must be offered.<sup>158</sup>

Credit card transactions also differ from other structured financings in that the sponsor has a continuing relationship with the borrowers. The sponsor may be in a business that depends on continuing sales to the card holders whose obligations are transferred to the issuer. In addition, the sponsor continues to own the accounts throughout the term of the financing, even though the receivables generated may be owned by the issuer. Accordingly, the sponsor

<sup>158</sup>See *Credit Card Deals Aren't Equal*, *supra* note 108, at 12. For example, one observer has estimated that, between January 1991 and December 1992, banks will be returning to their balance sheets more than \$6 billion of previously securitized credit card accounts receivable, representing approximately 14% of all credit card offerings by banks. See Kelley Holland, *Card-Backed Issuers Bracing for Repeat Securitizations*, AM. BANKER, Sept. 4, 1991, at 1.

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typically will make representations that it will not amend the terms of its credit card program so as to affect adversely the structured financing.

### c. Poorly Performing Assets

Interest in securitizing low quality and poorly performing assets has increased recently. Many of these assets are difficult to securitize because they lack the homogeneous characteristics necessary to assess credit risks easily.<sup>159</sup>

Almost all financings backed by these assets have been either privately placed in the United States or sold overseas, in part because of the application of the Investment Company Act.

The poorly performing assets most often securitized have been high yield or "junk" bonds. Finance companies, savings and loans, and insurance companies (directly or through affiliates), among others, have sponsored structured financings backed by high yield bonds to reduce their portfolio of these instruments. Savings and loans also are sponsoring structured financings to liquidate their high yield bond portfolios by 1994, as required by the Financial Institutions Reform, Recovery and Enforcement Act of 1989 ("FIRREA").<sup>160</sup> Other sponsors have acquired high yield bonds on the secondary market solely to repackage them to take advantage of the interest rate arbitrage.<sup>161</sup>

The structure used most frequently to securitize high yield bonds is the CBO. The payment of CBOs, like most types of structured financings, is derived from the cash flow from a relatively fixed pool of high yield bonds.<sup>162</sup> With

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<sup>159</sup>See *supra* text accompanying notes 45-47.

<sup>160</sup>Pub. L. No. 101-73, Title VI § 222, 103 Stat. 183, 270 (codified as amended at 12 U.S.C. § 1831e(d)). See also *Securitized Corporate Debt*, STANDARD & POOR'S CREDIT REVIEW: STRUCTURED FINANCE, Feb. 26 1990, at 3-4.

<sup>161</sup>See Donald J. Korn, *Split-Level Junking*, FINANCIAL PLANNING, Apr. 1990, at 79/81; Constance Mitchell, *One Man's Junk Becomes Another's CBO*, WALL ST. J., Dec. 14, 1989, at C1.

<sup>162</sup>The other structure used in securitizing high yield bonds is the market value structure. Securities issued using this structure differ from CBOs in that the payment on the securities is derived from the aggregate market value of the pooled bonds, rather than from the cash flow on the assets. The pooled assets are marked to market on a regular basis. If the market value declines beyond certain limits, then new collateral must be obtained. If the issuer is unable to raise the market value of the pool to the required limit, the pool is liquidated, with the proceeds used to retire the securities. All market value transactions are significantly overcollateralized, sometimes as much as 220%. See *Rating Cash Flow Transactions Backed by Corporate Debt*, MOODY'S (continued...)

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a typical CBO, however, bonds can be sold to prevent the deterioration of the pool or to capture appreciation of portfolio assets, with reinvestment of the proceeds in other high yield bonds meeting certain criteria.<sup>163</sup> CBOs can be issued as pass-through certificates or as multiclass sequential pay-through securities. Residual interests also may be sold.<sup>164</sup> For most CBOs, the senior class is rated by at least one rating agency.<sup>165</sup>

Another type of asset that has been securitized is the non-performing bank loan. A number of banks have considered disposing of their non-performing assets by establishing a spin-off entity, called a "bad bank," whose primary function is to liquidate those loans. Although there have been relatively few transactions to date, and each has been structured differently, the leading model is the Grant Street National Bank ("Grant Street") transaction, which occurred in October 1988. In this transaction, Mellon Bank Corp. ("Mellon") sold to Grant Street, a newly chartered bank established solely for the transaction,<sup>166</sup> non-

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<sup>162</sup>(...continued)

STRUCTURED FINANCE RESEARCH & COMMENTARY, Sept. 1989, at 6-8; *Junk Bond Securitization Initiated*, STANDARD & POOR'S CREDITREVIEW: ASSET-BACKED SECURITIZATION, Sept. 12, 1988, at 39.

<sup>163</sup>The rating agencies impose reinvestment criteria to ensure that the terms of the replacement securities reasonably match the terms of the bonds that were sold. See *High Yield Cash Flow Criteria*, STANDARD & POOR'S CREDITREVIEW: ASSET-BACKED SECURITIES, Mar. 27, 1989, at 88-89.

<sup>164</sup>Savings and loans previously were active in purchasing the residuals. In 1990, most of these securities were placed with international investors, particularly with Japanese accounts. See *FSA Reports No Claims As CBO Deal Is Scuttled*, GLOBAL GUARANTY, Sept. 10, 1990, at 1, 6.

<sup>165</sup>Theodore V. Buerger, et al., *An Overview of Securitization Risks*, in THE ASSET SECURITIZATION HANDBOOK, *supra* note 46, at 515. Some rating agencies may not monitor a CBOs portfolio for credit quality maintenance after issuance, unless new bonds are added or the CBO contains covenants requiring the manager to maintain a certain credit quality in the portfolio. See Anne Schwimmer, *Moody's May Downgrade First Boston CBO*, INV. DEALERS' DIG., July 1, 1991, at 17. Most CBOs appear to have weathered the recent downturn in the high yield bond market (see, e.g., *Junk Bond Structures Withstand Stress*, STANDARD & POOR'S CREDITREVIEW: STRUCTURED FINANCE, June 11, 1990, at 17-18), although at least one financing has been downgraded. See Schwimmer, *supra*. One CBO was liquidated when the holders of the equity interest decided to exercise a right to withdraw from the transaction. All senior debt holders were repaid at par. See *FSA Reports No Claims As CBO Deal is Scuttled*, *supra* note 164.

<sup>166</sup>As a bank, Grant Street was excepted from the Investment Company Act by section 3(c)(3).

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performing loans, foreclosed real estate, and other reposessed assets.<sup>167</sup> Grant Street purchased these assets with the proceeds of a public offering of two classes of rated debt obligations, with maturities of three and five years, respectively.<sup>168</sup> In addition, Mellon received Grant Street senior and junior preferred stock, and Grant Street common stock. Mellon distributed the common stock to Mellon's shareholders, and distributed the junior preferred to Grant Street directors.

Unlike most structured financings, the Grant Street assets were actively managed. Employees of Mellon were transferred to a subsidiary of Mellon that was dedicated solely to the servicing of the assets. The servicer had substantial discretion in the strategy employed for liquidating the assets. Mellon and the servicer received fees based on the amount of recoveries.

Grant Street retired the three-year term notes in six months due to the servicer shifting its strategy to accelerate collection more rapidly than initially planned, in part because of the deteriorating real estate market. The acceleration of the liquidation plan also resulted in almost half of the five-year notes being redeemed within one year of their issuance.<sup>169</sup>

Finally, highly leveraged transaction ("HLT") loans, primarily resulting from leveraged buyouts and other acquisition activity, have been securitized. As of June 1990, approximately \$2.5 billion of HLT loans had been securitized; another \$50 billion of HLT loans remained in the portfolios of large United States banks.<sup>170</sup>

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<sup>167</sup>The assets were sold at approximately 50% of their face value. See *Securitizing Problem Loans*, STANDARD & POOR'S CREDITREVIEW: ASSET-BACKED SECURITIZATION, Mar. 1989, at 82-83.

<sup>168</sup>Standard & Poor's rated the shorter-term class BBB-, while the other class was rated B-. *Id.* To our knowledge, bad banks are the only structured financings backed by poorly performing assets that have been publicly offered.

<sup>169</sup>Grant Street National Bank (*in liquidation*), STANDARD & POOR'S CREDITREVIEW: STRUCTURED FINANCE, Feb. 26, 1990, at 63.

<sup>170</sup>See Sheila M. Cahill & Susan R. Chalfin, *HLTs Still Hampered by a 50-Year-Old Law*, AM. BANKER, June 3, 1991, at 26.

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#### d. Master Trusts

One variant of the traditional structured financing structure is the "master trust." Master trusts have been used predominately in financings backed by credit card accounts receivable, but the structure may also be used to securitize other types of assets.<sup>171</sup>

As with traditional structured financings, the sponsor of a master trust transfers assets to a special purpose entity that issues securities backed by the assets. The master trust structure allows sponsors to transfer large amounts of assets at one time, however.<sup>172</sup> In addition, under certain conditions, assets may be added<sup>173</sup> or removed throughout the life of the trust.<sup>174</sup>

The master trust structure also permits the issuance of multiple series of securities over a period of time, with varying terms.<sup>175</sup> Each asset-backed

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<sup>171</sup>For example, Chrysler Financial Corp. recently sponsored a financing backed by "wholesale floorplan loans" that used the master trust format. Chrysler used this format to facilitate future securitizations. See Kathleen Devlin, *Chrysler Financial Returns for Dealer-Backed Notes*, INV. DEALERS' DIG., May 27, 1991, at 14.

<sup>172</sup>For example, the aggregate amount of assets initially included in the master trust sponsored by Citibank totalled \$6.4 billion; the Chase Manhattan Credit Card Master Trust was established with \$4.7 billion of assets. See *Standard Credit Card Master Trust I*, RTCH RESEARCH STRUCTURED FINANCE, Aug. 12, 1991, at 2; *Chase Manhattan Credit Card Master Trust Series 1991-2*, RTCH RESEARCH STRUCTURED FINANCE, Sept. 23, 1991, at 1-2.

<sup>173</sup>For example, under Citibank's master trust structure, receivables from new credit card accounts may be sold to the trust on a daily basis. Other receivables that may be added on a periodic basis include those arising from accounts acquired from other credit card issuers, accounts of a type that have not been previously securitized by Citibank, and accounts from maturing stand-alone trusts. Participations representing undivided interests in a pool of assets primarily consisting of credit card accounts receivable and their collections also may be added periodically. See Letter from Edward J. O'Connell, Vice President, Citibank, to Matthew A. Chambers, Assistant Director, Division of Investment Management, SEC 2 (Jan. 16, 1991), File No. 57-11-90.

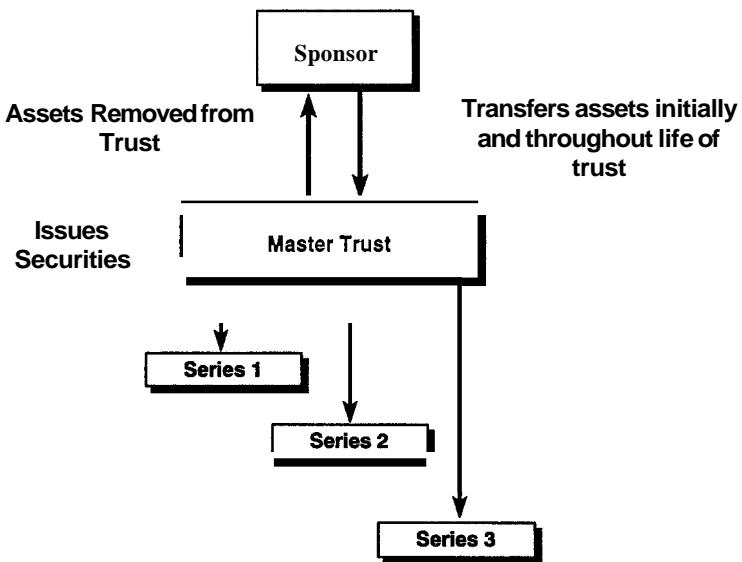
<sup>174</sup>Typically, such transactions may be effected only if at least one rating agency concludes that the addition or removal of assets will not result in the downgrading of any outstanding securities.

<sup>175</sup>For example, the first series of securities issued by the CARCO Auto Loan Master Trust paid a floating rate of interest; the second and third series were structured with fixed interest rates. See *CARCO Auto Loan Master Trust*, FITCH RESEARCH STRUCTUREDFINANCE, Aug. 26, 1991, at 2, 4, 6.

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security, regardless of the series to which it belongs, represents an undivided interest in the trust. The formula for allocating collections and administrative costs among the different series has varied among the master trusts thus far established.<sup>176</sup>

**FIGURE 1-7**  
**A Master Trust Structure**



The master trust structure offers several advantages over traditional structured financings. It permits a sponsor to securitize assets without the cost of establishing a new structured financing for each offering. Also, the size and diversity of the asset pool reduces the trust's volatility in performance, lessening credit and prepayment risk. These advantages make it possible that more sponsors will use this structure in the future.

#### e. Asset-Backed Commercial Paper Programs

Asset-backed commercial paper programs also are becoming increasingly popular. At year-end 1990, outstanding asset-backed commercial paper totaled

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<sup>176</sup>See Kravitt, *supra* note 103, § 4.03[D].

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\$50 billion, up from the previous year's total of \$42 billion.<sup>177</sup> Banks have sponsored most asset-backed commercial paper programs.<sup>178</sup> As with other structured financings, in an asset-backed commercial paper program assets are transferred to a special-purpose entity that issues securities backed by the assets. Asset-backed commercial paper programs differ from traditional structured financings in several significant ways, however.

First, most of these programs issue only commercial paper, on a continuing basis. The paper issued typically has a minimum denomination of \$100,000 and is highly rated.<sup>179</sup>

Second, commercial paper programs are backed by a diversified pool of assets that often are acquired from a number of different originators. Most pools contain a variety of relatively short-term assets, such as credit card receivables, auto lease receivables, trade receivables, equipment lease receivables, and short-term money market instruments.<sup>180</sup>

Third, the pool is not fixed, with additional assets being purchased throughout the life of the program, and, although the cash flow on the assets may be applied to repayment of maturing commercial paper, repayment of maturing paper is frequently funded with the proceeds from new issuances.<sup>181</sup> Thus, an asset-backed commercial paper program will not necessarily terminate when the

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<sup>177</sup>Kelley Holland, *Regulators Examine Risk of Asset-Backed Paper*, AM. BANKER, Mar. 12, 1991, at 16.

<sup>178</sup>As of year-end 1990, asset-backed commercial paper programs sponsored by banks had issued almost 90% of the asset-backed commercial paper outstanding. *Id.*

<sup>179</sup>At least one issuer has offered medium-term notes. See, e.g., Kravitt, *supra* note 103, §4.03[D], at 4-40. By offering medium-term notes the sponsor can minimize reliance on the commercial paper market.

<sup>180</sup>In some asset-backed commercial paper programs, the issuer may use the proceeds from the commercial paper to purchase higher coupon, longer-term assets in the secondary market. These assets include agency securities, mortgage loans, commercial loans, corporate bonds, and sovereign debt. See *Third-Party and Asset-Supported Commercial Paper*, MOODY'S STRUCTURED FINANCE RESEARCH & COMMENTARY, Nov. 1989, at 22-23.

<sup>181</sup>Liquidity usually is provided by a bank line of credit to support payment to commercial paper holders if the issuer is unable to roll over the commercial paper due to market conditions. See ROSENTHAL & OCAMPO, *supra* note 2, at 200; *Pooled Receivables' Robust Growth*, STANDARD & POORS CREDITREVIEW: ASSET-BACKED SECURITIZATION, Mar. 27, 1989, at 89-90.

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assets are paid off or deemed to be in default or when the Commercial paper initially issued matures.

These programs are attractive to originators for several reasons. First, unlike a traditional structured financing, which generally is not economically feasible with less than \$100 million in assets,<sup>182</sup> an asset-backed commercial paper program can be initiated with smaller pools.<sup>183</sup> The structure also permits securitization of diversified pools of assets. In addition, because asset-backed commercial paper programs, like master trusts, provide a continuing vehicle for securitizing assets, originators can securitize assets more readily once the program begins, without the cost of a new structure. Finally, originators may find asset-backed commercial paper programs attractive because commercial paper generally is exempt from registration under section 3(a)(3) of the Securities Act<sup>184</sup> and issuers of commercial paper may be excepted from the definition of investment company under section 3(c)(1) of the Investment Company Act.

## B. The Role of the Rating Agencies

The rating agencies play an integral role in most structured financings. There are *six* well-known rating agencies that provide credit ratings on debt securities, with four, Standard & Poor's Corporation ("S&P"), Moody's Investors Service, Inc. ("Moody's"), Fitch Investors Service, Inc. ("Fitch"), and Duff & Phelps, Inc., being particularly active in rating domestic structured financings.<sup>185</sup>

As with a traditional corporate bond, a rating of an asset-backed security assesses only credit risk, *i.e.*, the likelihood that the investor will receive full and timely payments. The rating generally does not address market risks to investors

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<sup>182</sup>Michael BeVier and Tom Kaplan, *Asset-Bucked Commercial Paper: Structure **With** Cure*, *AM. BANKER* (Special Adv. Supp.), May 30, 1989, at 5A.

<sup>183</sup>*Id.*

<sup>184</sup>15 U.S.C. § 77c(a)(3).

<sup>185</sup>The other most widely followed rating agencies are IBCA (which includes IBCA Limited and its subsidiary IBCA Inc.), a London based rating agency, and Thomson BankWatch. The Division met with S&P, Moody's, and Fitch in the course of its review. Generally, the rating categories used by the various rating agencies are similar for investment grade securities. In addition, their general methodologies for rating structured financings appear to be similar, although the criteria for a given rating vary among the agencies.

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that may result from changes in interest rates or from prepayments on the underlying asset pool.<sup>186</sup>

Almost all structured finance fixed-income securities offered publicly are rated by at least one rating agency,<sup>187</sup> with most containing at least one class of securities that is rated in one of the top two categories.<sup>188</sup> The larger, privately placed financings are often rated, with the range of ratings being much broader. The fact that structured financings are subject to the scrutiny of the rating agencies and are typically rated in one of the top two rating categories makes them attractive to some investors.<sup>189</sup>

We discuss below the role of the rating agencies in structured financings. We first review the process of obtaining a rating and the factors used to determine a rating. We then focus on the use of credit enhancements. Finally, we describe what happens after the rating is given.

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<sup>186</sup>Of course, the ratings are based primarily on the information supplied to the rating agencies. Thus, ratings do not address fully the possibility of inaccurate information or fraud, although the agencies often insist on verification of information by independent auditors and others.

<sup>187</sup>With the exception of securities backed by residential mortgages, most publicly offered structured financings are rated by two rating agencies.

<sup>188</sup>*See, e.g.*, DEAN WITTER, *supra* note 38, at A-28. In 1991, a large majority of structured financings involving automobile loans, credit card receivables, and home equity loans were rated AAA, although some lower-rated transactions were issued. *Id.* at A-29. Other types of non-mortgage financings do have AA, or lower, ratings. *See id.* Mortgage-backed securities offered by the federal agency programs have an implicit AAA rating and are not subject to rating agency scrutiny. To be a "mortgage-related security" under the Exchange Act, a security must be rated AAA or AA. Exchange Act § 3(a)(41), 15 U.S.C. § 78c(a)(41). Finally, some multiclass transactions (mortgage and non-mortgage) contain classes that, if rated, are rated lower than AA. *See, e.g.*, DEAN WITTER, *supra* note 38, at A-29.

<sup>189</sup>Because of the complexity of structured financings, it appears that many investors rely heavily upon the rating of these securities in making their investment decisions. Of course, many other investors also conduct their own due diligence review. See *supra* text accompanying note 74.

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## 1. Rating the Deal

### a. The Process

The process for rating a structured financing is generally the same regardless of the underlying assets. The sponsor and/or its underwriter meets with a rating agency to discuss the proposed structure and provide an overview of the sponsor's business. A rating agency may not agree to rate the transaction if it believes that the assets being used do not have sufficient credit history to enable the rating agency to predict the pool's future performance. A rating agency also may decline to rate the transaction if the company originating the assets is a new company.<sup>190</sup> If rating the proposed transaction appears viable, the sponsor and/or underwriter officially requests that the rating agency rate the transaction, and agrees to provide all relevant information.<sup>191</sup> The sponsor and/or underwriter also agrees to pay the rating agency for its rating services.<sup>192</sup>

In determining the rating, the rating agency reviews the relevant documentation regarding the transaction, including the P&S agreement, the prospectus or private placement memorandum, and any indenture. The rating agency also may conduct an on-site due diligence inspection of the sponsor and the servicer. Typically, the agency reviews the underwriting and servicing operations, particularly the credit and collection processes. This may entail tracking an application through the credit review and approval process and tracking collection on a delinquent receivable. The historical, current, and expected performance of the sponsor's portfolio (from which the pool will be taken) also may be discussed. In addition, the rating agency may review whether

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<sup>190</sup> See e.g., *Start-up Companies Pose Risk*, STANDARD & POORS CREDIT REVIEW: ASSET-BACKED SECURITIZATION, Mar. 1989, at 5. For example, as of March 1989, S&P had never rated asset-backed securities supported by assets from a start-up company, because of the material risks these companies face. Id. As of that date, S&P insisted on a minimum of one to two years' operating history and receivables performance, unless the assets were originated by a new business unit of an established operating company.

<sup>191</sup> Fitch and S&P rate transactions only upon request. Moody's rates every publicly offered transaction regardless of whether it is asked and compensated. According to Moody's, sponsors provide them with information necessary to rate the deal because it is in a sponsor's best interest to do so.

<sup>192</sup> S&P's fees, for example, range from \$8,000 to \$75,000 with additional "surveillance" fees of \$500 to \$2,500, although S&P may charge special fees for new vehicles.

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the sponsor has the capability to track the assets that will be pooled separately from the overall portfolio.<sup>193</sup> Finally, an agency will review its own internal resources to obtain information about the sponsor, historical performance data on the type of assets being securitized, and other relevant information.

After completing its review, the agency's rating committee decides on a rating. The decision is then communicated to the underwriter. Typically, the rating process may take several weeks, although more complicated transactions have taken over a year, depending in part on whether the financing involves a type of asset previously securitized.

### **b. Determining the Rating**

A structured financing is rated so that the credit risk is equivalent to the credit risk of a corporate bond, or other security, rated in the same category. Similarly, regardless of the nature of the underlying assets, a structured financing is rated so that all financings that are rated in a particular category are deemed to have equivalent credit risk.<sup>194</sup>

Rating agencies apply the same basic criteria to almost all structured financings that issue securities with maturities exceeding one year.<sup>195</sup> They analyze the structure of the transaction, including the quality of the assets, and

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<sup>193</sup>These on-site meetings do not necessarily duplicate the due diligence performed by many underwriters. Rather, the rating agency may review the underwriter's due diligence process, work and results. *See, e.g., Competition Threatens "Due Diligence" Standards*, MOODY'S STRUCTURED FINANCE RESEARCH & COMMENTARY, Dec. 1988, at 3. According to Moody's, increase in the number of intermediaries entering the field, and the "commoditization of the business created by an increase in volume and augmented by the negotiating power of large, repeat issuers have resulted in competitive pressures on underwriters to lower their underwriting fees and cut back on the expensive due diligence process. *Id.* If Moody's finds that the due diligence conducted by the underwriter is less than satisfactory, it requires a higher level of credit support to achieve a given rating. *Id.* See *Structured Finance Annual Report: 1989 Review and 1990 Outlook*, MOODY'S STRUCTURED FINANCE RESEARCH & COMMENTARY, Jan. 1990, at 5-6.

<sup>194</sup>According to Moody's "[r]atings for structured finance classes are intended to be consistent with ratings assigned to corporate, municipal, and other structured finance securities . . . the expected reduction in annual yield from credit losses should be approximately the same for two equally rated securities." *See Rating Whole-Loan Bucket Multiclass Securities*, *supra* note 129, at 11.

<sup>195</sup>Asset-backed commercial paper programs are subject to somewhat different rating criteria, in part because of their need to have the liquidity to pay off commercial paper when due. *See supra* note 181 and accompanying text.

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then determine the amount of credit enhancement that is needed for the transaction to obtain the rating category desired by the sponsor. In reviewing the structure, a rating agency generally looks at three areas: legal issues, credit quality, and cash flow.

### (1) Legal Issues

One legal question inherent in structured finance is whether the issuer's assets and the cash flow on those assets will be available to pay investors in a timely manner notwithstanding the insolvency or bankruptcy of the sponsor. Rating agencies have developed criteria to address this question. If these criteria are not met, the rating on the securities generally will not be higher than the sponsor's rating.<sup>196</sup>

The criteria depend on whether the sponsor is subject to the Bankruptcy Code. Section 362 of the Bankruptcy Code provides that the filing of a bankruptcy petition automatically stays all creditors from exercising their rights with respect to the sponsor's assets.<sup>197</sup> Unless a financing is structured properly, a stay could prevent investors from receiving full and timely payment. Although bankruptcy courts may lift stays under certain circumstances, even if a stay is lifted, timely payment to investors could be jeopardized. Furthermore, under some circumstances other provisions of the Bankruptcy Code could be interpreted as permitting the assets and the cash flow on them to be returned to the sponsor.<sup>198</sup>

If a sponsor is subject to the Bankruptcy Code, the agencies typically review two related items. First, the rating agencies examine whether the assets and liabilities of the issuer are likely to be consolidated with those of the sponsor

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<sup>196</sup>See, e.g., S&P's STRUCTURED FINANCE CRITERIA, *supra* note 108, at 33. Rating agencies may conclude, on a case-by-case basis, that the likelihood of a sponsor becoming insolvent during the term of the structured financing is sufficiently remote to overcome noncompliance with some of these criteria. *Id.* at 34.

<sup>197</sup>11 U.S.C. § 362.

<sup>198</sup>For a more detailed discussion of structured financings and the Bankruptcy Code, see generally Thomas S. Kiriakos, et al., *Bankruptcy*, in 1 SECURITIZATION OF FINANCIAL ASSETS, *supra* note 21, at §§ 5.01-5.06; Thomas W. Albrecht, *Securitising Receivables: Protecting Against Bankruptcy*, 9 INT'L. FIN. L. REV. 33-37 (Sept. 1990); Steven L. Schwarcz, *Structured Finance: The New Way to Securitize Assets*, 11 CARDOZO L. REV. 607,611-627 (Feb. 1990); Neil Baron, *Asset-Backed Securities and U.S. Bankruptcy Laws*, 6 INT'L. FIN. L. REV. 19-23 (Dec. 1987).

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in a bankruptcy proceeding. To address this concern, the rating agencies examine whether the issuer is separate from the sponsor. Factors demonstrating this separation include whether the issuer maintains separate books and records and office space from the sponsor, maintains separate accounts from the sponsor, and, in the case of a corporation, observes appropriate corporate formalities.<sup>199</sup> In addition, the agencies may require an opinion from counsel that the assets and liabilities of the issuer would not be consolidated with the sponsor in the event of the sponsor's bankruptcy.<sup>200</sup>

The rating agencies also examine whether the transfer of the assets from the sponsor to the issuer is a true sale and not a secured loan. If the transaction is characterized as a secured loan, the pooled assets may be deemed to be assets of the sponsor. The rating agencies look for indicia of a sale, which may include that the transfer is treated as a sale for accounting and tax purposes, that the level of recourse to the sponsor is less than a reasonably anticipated default rate (based primarily on historical default data),<sup>201</sup> that the sponsor does not retain the benefits of ownership of the transferred assets (*i.e.*, that the sponsor may not receive any of the assets' appreciation or their cash flow), and that neither the assets nor their cash flow is commingled with the property of the sponsor.<sup>202</sup> The rating agencies also may require an opinion from counsel that the transfer of the assets from the sponsor to the issuer would be characterized by a court as a sale ("true sale opinion").<sup>203</sup> In transactions where a true sale opinion is given but not all indicia of a sale are met, the rating agencies may consider the financial strength of the sponsor in determining the rating.<sup>204</sup>

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<sup>199</sup>See Darrow, et al., *supra* note 21, § 7.03[C]; see generally Kiriakos et al., *supra* note 198, § 5.05(G).

<sup>200</sup>See Darrow et al., *supra* note 21, § 7.03[C]; S&P'S STRUCTUREDFINANCE CRITERIA, *supra* note 108, at 34, 69.

<sup>201</sup>Recourse may take several forms, such as the retention of a subordinate class or the obligation to repurchase defaulted assets, the substitution of good assets for defaulted assets, or the reimbursement of a third party credit enhancer. See *Legal Issues in Transferring Assets*, STANDARD & POOR'S CREDITREVIEW: ASSET-BACKED SECURITIZATION, Mar. 1989, at 7.

<sup>202</sup>See *id.* at 7. See also Darrow et al., *supra* note 21, § 7.03[B].

<sup>203</sup>See *Legal Issues in Transferring Assets*, *supra* note 201, at 7-8.

<sup>204</sup>*Id.*

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The insulation of the structured financing from sponsor insolvency is less difficult for sponsors that are not subject to the Bankruptcy Code, such as banks and savings and loans. Generally the rating agencies have concluded that such sponsors may pledge, instead of sell, the assets to the issuer (or, in some cases, to the investors), if the issuer (or investors) have at least a first perfected security interest in the assets.<sup>205</sup> In addition, the rating agencies require an opinion of counsel that the investors' rights with respect to the assets of and the cash generated by the financing would be enforceable in the event of the insolvency or receivership of the seller or pledgor of the assets.<sup>206</sup>

The rating agencies also evaluate whether the issuer itself could become the subject of bankruptcy proceedings. To minimize this risk, the rating agencies may require, among other things, that the issuer restrict its business to the purchase of the assets and the issuance of securities, incur additional debt only in limited circumstances, be capable of paying for expenses out of its capital and revenues, and be able to institute bankruptcy proceedings only in limited circumstances.<sup>207</sup>

## (2) Credit Quality

The most important and time consuming role of the rating agencies is analyzing the credit risk of the financing. The principal credit risk in a structured financing is the potential impairment of cash flows resulting from shortfalls due to borrower delinquencies or losses due to defaults.<sup>208</sup>

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<sup>205</sup>See Darrow, et al., *supra* note 21, § 7.03[B]; S&P's STRUCTURED FINANCE CRITERIA, *supra* note 108, at 70.

<sup>206</sup>See S&P's STRUCTURED FINANCE CRITERIA, *supra* note 108, at 70. As of October 1, 1990, savings and loans had been quite successful in insulating their structured financings from their own insolvency. As of that date, no structured financing sponsored by a failed savings and loan had defaulted as a result of a sponsor's insolvency, although several issues had been redeemed or accelerated. See *Bright Spot in S&L Crisis*, FITCH INSIGHTS, Oct. 1, 1990, at 7.

<sup>207</sup>S&P's STRUCTURED FINANCE CRITERIA, *supra* note 108, at 29-30, 70; Darrow et al., *supra* note 21, § 7.03[D].

<sup>208</sup>Credit and legal analysis are closely related. A high credit quality may mitigate rating agency concerns relating to legal risks. Darrow et al., *supra* note 21, § 7.02[C]. Also, with enough credit enhancement, a structured financing with a perceived "risky" sponsor may nevertheless receive a high rating.

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The rating agencies typically evaluate a sponsor's historical and expected financial performance, organizational strengths and weaknesses, and competitive position in the industry from which the assets are being sold. The rating agencies also examine the characteristics of the sponsor's portfolio from which the pool will be drawn, including any relevant customer concentrations,<sup>209</sup> historic origination and repayment statistics, and delinquency and loss statistics.<sup>210</sup>

The process of selecting a pool from the portfolio is critical. The agencies generally prefer that a pool be representative of the portfolio. The selection is usually done randomly, although, in some cases, the assets for the pool are "cherry picked." If the latter method is used, however, the pool may not consist of predominately lesser quality assets. Typically, an independent auditor confirms that the pool is representative of the sponsor's portfolio.<sup>211</sup>

The rating agencies forecast pool performance by examining the credit characteristics of the assets. While the factors used and their weightings differ depending on the type of assets, they invariably include the historical performance of the assets.<sup>212</sup> The methodology used also varies according to the type of assets. Typically, rating agencies use an actuarial or statistical approach to make generalized assumptions regarding future Performance when a pool contains a large number of assets with homogenous characteristics, such as credit card receivables, auto loans, or home equity loans. Where a pool contains a small number of assets, typically with limited standardization, such as high yield bonds, probable future performance is assessed by examining each asset.

The rating agencies attempt to predict whether the financing will pay full and timely interest and principal in a "worst case" scenario. The transaction must

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<sup>209</sup>One important factor is the diversification by borrower and geographic area of the assets.

<sup>210</sup>In selecting the pool, however, the sponsor may improve the credit quality by excluding from the portfolio delinquent and unseasoned accounts and reducing geographic concentrations.

<sup>211</sup>An unrepresentative sample may add expense to the sponsor, resulting from either the need for additional credit enhancement or a lower rating. To market a security with a lower rating, a higher yield is needed, reducing the proceeds received by the sponsor.

\*For example, to obtain performance criteria for automobile loan and credit card-backed transactions, S&P reviewed more than 10 years of history, over a number of economic cycles.

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be structured to be able to survive this scenario to obtain the desired rating.<sup>213</sup> In theory, the rating will not change even if this scenario does occur. Thus, in a highly rated financing, the transaction is structured so that the assets' performance would have to deteriorate greatly before investors in the fixed-income securities would not be fully paid.

As part of the review of the credit quality of the transaction, rating agencies evaluate the servicer.<sup>214</sup> The quality of servicing may be important to the rating, depending on the importance of the servicer's responsibilities.<sup>215</sup> The rating agencies evaluate the servicer in terms of its responsibilities to manage and maintain the payment stream on the underlying assets. The rating agencies generally insist that a servicer that is not rated as high as the fixed-income securities not commingle its own funds with the cash flow from the transaction, but remit the cash flow to the trustee within forty-eight hours.<sup>216</sup> The rating agencies also ~~will~~ take into consideration the servicer's rating if the servicer is responsible for making advances on delinquent assets or repurchasing assets that have defaulted.<sup>217</sup>

In addition, the rating agencies have developed criteria for permitting reinvestment of cash flows in short-term investments?" such as commercial

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<sup>213</sup>For example, Fitch uses the mortgage default patterns in Texas during the 1980's as benchmarks for assessing the credit loss levels of mortgage-backed securities. *See Mortgage Criteria Update*, FITCH RESEARCH STRUCTURED FINANCE (Special Report), July 8, 1991.

<sup>214</sup>The rating agencies also may evaluate the trustee. Because generally only a few entities act as trustees for structured financings, the rating agency generally will not perform any due diligence if one of these entities is trustee. For a discussion of the rating agencies' concerns with respect to the trustee, see Darrow et al., *supra* note 21, § 7.02[D][3].

<sup>215</sup>For example, Moody's has stated that extremely weak servicing could result in an otherwise AAA transaction being given an A or AA rating. *The Servicer in Securitized Transactions*, *supra* note 100, at 12.

<sup>216</sup>*See, e.g.*, S&P's STRUCTURED FINANCE CRITERIA, *supra* note 108, at 67. A rating agency's concern also may be alleviated if the servicer obtains a letter of credit or some other form of credit enhancement.

<sup>217</sup>*See* Darrow et al., *supra* note 21, § 7.02[D][2].

<sup>218</sup>*See, e.g.*, *Eligible Investment Guidelines in Structured Securities*, MOODY'S STRUCTURED FINANCE RESEARCH & COMMENTARY, Feb/Mar. 1990, *reported in Moody's Approach to Rating Residential Mortgage Pass-Throughs*, MOODY'S STRUCTURED FINANCE RESEARCH & COMMENTARY (Special Report), Apr. 1990, at 45.

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paper, which may include paper issued by the sponsor. Finally, the rating agencies evaluate the amount and method of payment of the servicing fee and the difficulty of obtaining an alternative servicer, if necessary.<sup>219</sup>

### (3) Cash Flow Analysis

Cash flow analysis examines the risks related to the cash flow funding the securities. Rating agencies examine the cash flow generated by the underlying assets. Such an examination may include, among other things, a review of the assets' payment speeds, delinquency and loss rates, and interest rates and basis risks.<sup>220</sup> The agencies also analyze the allocation of the cash flow, including the financing's payment structure. For example, with respect to a financing using a pay-through structure, the rating agencies may examine how the financing addresses concerns relating to the reinvestment of cash flows prior to payment, the calculation of stated maturities, and the trustee's powers with respect to the assets in the event of a default.<sup>221</sup>

## 2. Credit Enhancement

Once the structure is analyzed, the agencies determine the amount of credit enhancement needed to obtain the desired rating. Credit enhancement is intended to protect investors from the continuing effects of shortfalls due to borrower delinquencies or losses due to defaults, or other adverse events.

Most structured financings include some credit enhancement. The amount of enhancement needed for a given rating depends on the historical performance of the assets<sup>222</sup> and the structure of the transaction. Consequently, the actual

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<sup>219</sup>The rating agencies may insist that the fee be a percentage of the outstanding principal balance and be subordinated to payments of principal and interest to investors. S&P's STRUCTURED FINANCE CRITERIA, *supra* note 108, at 68.

<sup>220</sup>See *Asset Securitization and Secondary Markets: Hearings Before the SubComm. on Policy Research and Insurance of the House Comm. on Banking, Finance and Urban Affairs*, 102nd Cong., 1st Sess. 4-5 (July 31, 1991) (statement of Clifford Griep, Executive Managing Director, Structured Finance Rating Department, S&P's Rating Group).

"See S&P's STRUCTURED FINANCE CRITERIA, *supra* note 108, at 66-67; Darrow et al., *supra* note 21, § 7.02[E].

<sup>222</sup>Thus, the amount of credit enhancement depends on the assets. For example, without credit enhancement, most credit card transactions would be rated BB or BBB. Credit enhancement is necessary for an AAA rating. See *Credit-Card Deals Aren't Equal*, *supra* note 108, at 12. Because (continued..)

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amount of credit enhancement in a structured financing largely depends on what rating the sponsor believes is needed to sell the securities and what a rating agency requires for the transaction to obtain that rating.

Credit enhancements can be divided into two types: external and internal. External credit enhancements are provided by the sponsor or highly rated third parties; internal credit enhancements are those structural protections inherent in the design of the financing.

The most common external credit enhancements are irrevocable standby letters of credit ("LOCs"), sponsor guaranties or "recourse," and financial guaranty insurance. External credit enhancements are more common than internal enhancements, but their use has declined somewhat because the rating of a structured financing depends on that of the provider of the credit enhancement. If the provider subsequently is downgraded below the rating of the structured financing, the structured financing likewise may be downgraded.

Historically, LOCs have been the most common external credit enhancements.<sup>223</sup> Typically, an LOC provides a limited guaranty against defaults and payment delinquencies up to either a fixed dollar amount or a percentage of the outstanding principal balance of the financing. The amount of the LOC depends on the particular transaction and the underlying assets.<sup>224</sup> Draws against the LOC provider limit the coverage amount available. The LOC provider may be reimbursed by the sponsor, from a reserve account that is funded by the sponsor, or by excess cash flow on the assets.<sup>225</sup>

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<sup>222</sup>(...continued)

the historical loss experience of a pool of credit card receivables is typically lower and less variable than a pool of high yield bonds, the amount of credit enhancement needed to obtain an AAA rating on a credit card pool is much lower than that needed for a CBO. In fact, most CBOs are not rated AAA in part because of the expense of the requisite credit enhancement.

<sup>223</sup>Approximately 26.2% of all non-mortgage structured financings issued as of year-end 1991 used an LOC as the sole means of credit enhancement. **DEANWITTER**, *supra* note 38, at A-23. An additional 17.3% used an LOC in conjunction with some other credit enhancement. *Id.*

<sup>224</sup>For example, LOC coverage on credit card transactions existing as of April, 1990 ranged from 5%-30%or a stated dollar amount. *See Credit-Card Deals Aren't Equal*, *supra* note 108, at 13.

<sup>225</sup>LOCs reimbursed by a reserve fund are used in almost all transactions in which the sponsor is a bank because reserve accounts are not considered recourse for purposes of regulatory requirements. *See supra* note 99.

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Most LOCs have been provided by foreign commercial banks, primarily because of the limited number of AAA-rated United States banks.<sup>226</sup> Recently, however, many foreign commercial banks have experienced rating downgrades, resulting in the downgrading of structured financings supported by LOCs from these banks.<sup>227</sup> Accordingly, many sponsors have turned to other credit enhancements.<sup>228</sup>

Sponsor guaranties or recourse require the sponsor to cover any losses up to either a fixed dollar amount or a fixed percentage of the declining principal balance of the financing. It may be used alone or, more typically, in conjunction with some other form of credit enhancement. Because the rating of the structured financing will not be higher than that of the sponsor, this form of credit enhancement is used only by highly rated sponsors. It also generally is not used in savings and loan or bank-sponsored structured financings because of regulatory requirements.<sup>229</sup>

Financial guaranty insurance policies typically guarantee the timely payment of principal and interest in accordance with the insurer's original payment schedule during the term of the structured financing. According to insurers, in deciding whether to issue a financial guaranty, they underwrite to a zero-loss standard, rather than using actuarial assumptions about future

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<sup>226</sup>Of the 13 largest LOC providers for non-mortgage structured financings as of year-end 1991, only two (Morgan Guaranty Trust Co. of N.Y. and State Street Bank and Trust Company) were United States banks, each having provided LOCs for three issues. DEAN WITTER, *supra* note 38, at A-33. The leading LOC provider as of that date was Union Bank of Switzerland (61 issues), followed by Credit Suisse (38 issues). *Id.*

<sup>227</sup>See, e.g., *Downgrade: To Aa1 Credit Ratings on Letter-Of-Credit-Supported And Guaranteed Issues of Dai-Ichi Kangyo Bank*, MOODY'S STRUCTURED FINANCE RESEARCH AND COMMENTARY, Aug. 1990, at 49; *Downgrade From Aaa to Aa1: Credit Ratings on Letter-@-Credit-Supported and Guaranteed Issues of Fuji Bank, Ltd.*, MOODY'S STRUCTURED FINANCE RESEARCH & COMMENTARY, Aug. 1990, at 48.

<sup>228</sup>One relatively new form of credit enhancement is the "cash collateral account." In a cash collateral account, a third party deposits cash in a trust prior to the offering. The cash may be drawn upon during the life of the issue if needed and is typically invested in highly rated short-term securities with the income allocated to the depositor. See *Cash Collateral Support for ABS Hot New Financial Product in NY*, THOMSON'S GLOBAL ASSET BACKED MONITOR, Apr. 12, 1991, at 1-2.

<sup>229</sup>See *supra* note 99.

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claims.<sup>230</sup> Guarantors often require that other types of credit enhancement also be obtained.

Financial guaranties typically are obtained from insurers who are rated AAA by at least one rating agency. Because these guaranties are expensive, they usually are used only in types of structured financings that are new or perceived as being more speculative (such as CBOs).<sup>231</sup>

Internal credit enhancements have become more common. The most common types are overcollateralization, spread accounts, senior/subordinated structures, and payout or amortization events.

Overcollateralization means that the amount of the assets in the pool exceeds that needed to make full payment on the securities and to pay expenses. The cash flow from the excess collateral offsets any defaults or delinquencies on the assets. Many financings use overcollateralization, usually in conjunction with some other credit enhancement.

Spread accounts are escrow accounts whose funds are derived from the spread between the interest earned on the assets in the underlying pool and the amount needed to pay servicing fees and interest on the securities.<sup>232</sup> Typically, the differential in interest (less fees) is placed in the account as the payments are made on the underlying pool until the account reaches a stated level. Any additional spread is returned to the sponsor or to residual interest holders, while the funds in the spread account provide credit support. When the fixed-income securities are completely paid off, the remaining funds in the spread account either return to the sponsor or residual holders.

The senior/subordinate structure uses two different classes of securities, with the senior class having the first claim on the cash flow. Thus, the

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<sup>230</sup>See, e.g., FINANCIAL SECURITY ASSURANCE, 1989 ANNUAL REVIEW 6 (1990).

<sup>231</sup>For more information on the financial guaranty industry, see *Bund Insurers' Turbulent Future*, FITCH FINANCIAL INSTITUTIONS (Special Report), June 4, 1990.

<sup>232</sup>For example, for a transaction in which the pool of assets has a yield of 20%, the investor coupon of the asset-backed security has a yield of 10%, and the servicing fee is 2.5%, the spread would be 7.5%, assuming no defaults and no other expenses.

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subordinate class absorbs credit losses before any are charged to the senior class. The amount of coverage by the subordinate class varies by transaction.<sup>233</sup>

Payout or amortization events are events specified in the P&S agreement that trigger early retirement of the securities and are intended to ensure that investors in the fixed-income securities receive all principal and accrued interest. Payout events have included charge-offs on assets rising above a certain level for specified periods or the net yield on the assets falling below certain levels for specified periods. This form of credit enhancement has been used primarily in financings backed by revolving accounts receivable, where all principal payments on receivables may be used to amortize the remaining balances, rather than reinvest in new receivables.<sup>234</sup>

At least one financing has accelerated payment as a result of the occurrence of a payout event.<sup>235</sup> Investors received all principal and interest due. Of course, acceleration causes investors to lose interest payments they would have received had the financing continued. In addition, if prevailing interest rates have declined, investors must reinvest in lower yielding instruments.

Most structured financings allow for asset substitution to protect the credit quality of the pool, although this is not considered to be a credit enhancement. Assets often are substituted for similar assets that are deemed defective, or, after pooling, are determined not to meet the requirements of the P&S agreement. In addition, some structured financings include a "defeasance mechanism." This mechanism permits the trustee to sell assets in the pool and to use the proceeds to purchase Treasury bills that will, in turn, provide sufficient cash flow so that investors will receive full and timely principal and interest payments.

### **3. Monitoring a Financing**

Once a financing is rated, the rating agencies typically monitor its performance monthly or quarterly. The agencies review factors such as asset

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<sup>233</sup>For example, the typical subordinate loss coverage of structured financings backed by credit card receivables ranges from 7% to 15% of the original outstanding principal amount. See *Credit-Card Deals Aren't Equal*, *supra* note 108, at 13. If the loss ratio is 10%, a \$100 million pool may be divided into \$90 million senior securities and \$10 million subordinate securities, with investors holding the senior securities being protected for up to \$10 million in losses.

<sup>234</sup>See *supra* note 157 and accompanying text.

<sup>235</sup>See *Credit Card Prepayment Risk*, STANDARD & POOR'S CREDIT WEEK, July 1, 1991, at 45.

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performance, including default and delinquency rates, and the credit enhancement, including whether there has been any change in the creditworthiness of a credit enhancement provider. Historically, downgrades have been infrequent, although they have increased in recent years.<sup>236</sup>

Most downgrades have occurred as a result of downgrades in the rating of the providers of external credit enhancements. Downgrades due to poor pool performance have been rare, perhaps because the rating agencies, in determining the amount of credit enhancement needed for a high rating, incorporate delinquency and loss levels of three to five times historical performance. Very few of the downgrades have resulted in the securities being rated below investment grade.<sup>237</sup>

On occasion, a financing may be restructured to preserve a rating. Typically, a financing is restructured to provide added credit enhancement to support the pool. The sponsor generally has an additional incentive to add such support, so that it may sponsor additional financings.<sup>238</sup>

### C. Unrated Transactions

Not all structured financings are rated. Most unrated structured financings are privately placed. These transactions are relatively small, and because of their size, sponsors may find it uneconomical to obtain a rating.

The structure of unrated private placements varies. Some transactions look very similar to those that are rated and sold publicly, but many do not. For example, the issuer may not be bankruptcy-remote or an unrated servicer may commingle the cash flow with its own funds. The assets may not consist of a representative sampling of the portfolio; in fact, in some transactions the sponsor's entire portfolio may be securitized. Finally, these transactions may not have any

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<sup>236</sup>See *Annual Report: 1990 Review & 1991 Outlook, MOODY'S STRUCTURED FINANCE RESEARCH & COMMENTARY (Special Report)*, 1991, at 3.

<sup>237</sup>The Division knows of only two financings that have been downgraded below investment grade. According to S&P, it is highly unlikely that an AAA rated asset-backed issue suddenly could be downgraded below investment grade as a result of some unforeseen event, given the structure of such highly rated transactions. See *Asset-Backed Event Risk and the Seller's Rating*, STANDARD & POOR'S CREDITREVIEW, June 1990, at 15.

<sup>238</sup>See, e.g., Steven Lipin, *Citicorp Acts to Prop Rating of its Securities*, WALL ST. J., Oct. 24, 1991, at C1.

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credit enhancement. Investors may not be concerned about the lack of these attributes because they are involved in structuring the transaction, and are familiar with the sponsor and the assets.<sup>239</sup>

Some unrated financings have been sold publicly. Many of these financings were mortgage-backed securities that were sold prior to the enactment of SMMEA.<sup>240</sup> Today, almost all publicly offered financings issue at least one highly rated class of securities.

Unlike rated structured financings, there have been instances where unrated structured financings have defaulted. The largest and most notable of these defaults occurred in 1985, when Equity Programs Investment Corporation ("EPIC"), and certain of its affiliates, defaulted on approximately \$1.4 billion in mortgages and privately placed mortgage-backed securities.<sup>241</sup>

Beginning in 1975, EPIC organized, syndicated, operated, and served as general partner of real estate limited partnerships with interests in model homes that were purchased from home builders.<sup>242</sup> Subsequently organized partnerships invested in unsold homes also purchased from home builders. Much of the partnership property was located in the southwest section of the United States. Mortgages on the properties were obtained from an EPIC affiliate, typically at ninety-five percent of the properties' appraised value. EPIC represented that, during the period of the partnership, the residential units were to be leased back to the builders or leased for tenant occupancy, with an EPIC

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<sup>239</sup>For example, banks often invest in structured financings sponsored by their customers.

<sup>240</sup>See Sears Mortgage Securities Corp. (pub. avail. May 21, 1985) (stating that traditional shelf registered "mortgagerelated securities" were direct pass-through securities that differed from the definition of the term "mortgagerelated security" in section 3(a)(41) of the Exchange Act (15 U.S.C. § 78c(a)(41)) "primarily because they had not received a rating from a nationally recognized statistical rating organization").

<sup>241</sup>The first two EPIC-sponsored financings were rated by S&P and investors did not experience any loss. Those offerings were structured differently from the unrated financings that were subsequently issued (and that defaulted) in terms of, for example, their underlying collateral and loss coverage. See *infra* notes 248-249 and accompanying text.

<sup>242</sup>The facts summarized below are derived in part from the opinion issued in *re EPIC Mortgage Ins. Litig.*, 701 F. Supp. 1192 (E.D. Va. 1988), *aff'd* in part, *rev'd* in part, sub nom. *Foremost Guaranty Corp. v. Meritor Sav. Bank*, 910 F.2d 118 (4th Cir. 1990). The EPIC default resulted in extensive litigation initiated by two insurance companies that had insured some of the mortgages backing the defaulted securities. See *infra* note 247 and accompanying text.

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affiliate managing the property. The mortgage obligations were to be paid through the rental income, builders' rebates to EPIC (called "rental deficit contributions"), the limited partner's capital contributions, and if necessary, advances from EPIC. EPIC represented that funds obtained through these sources would be used for the sole benefit of each individual partnership. Under the contemplated arrangement, the properties would be sold, typically after four years, and the partnership liquidated, with the profits distributed to the partners.<sup>243</sup> By mid-1985, EPIC managed over 18,000 partnership homes owned by more than 350 limited partnerships.

From January 1980 through July 1985, EPIC privately placed approximately \$935 million in pass-through securities backed by pools of mortgages on partnership properties. Credit enhancement consisted of private mortgage insurance that covered up to a certain percentage of any loss.<sup>244</sup> An EPIC affiliate was the servicer, with the underlying mortgages assigned to an independent trustee.

The actual operation of the EPIC enterprise differed significantly from that which was represented. First, EPIC partnerships did not operate as separate entities. Rather, EPIC commingled the funds of each partnership with its general funds, and then advanced such funds to the various partnerships based solely upon the partnership's needs. In addition, the EPIC companies were unable to sell the partnership properties and, beginning in 1984, new partnership interests, both of which resulted in shortfalls of funds. EPIC subsequently became dependent on the acquisition of new properties and the formation of new types of partnerships to generate the funds to pay obligations of older partnerships, and in turn, the outstanding mortgage-backed securities.<sup>245</sup> In 1982, EPIC acquired Community Savings and Loan, Inc., to eliminate EPIC's cash concerns; as of May 1985, the savings and loan had advanced over \$26 million to the EPIC limited partnerships, primarily in the form of unsecured second trust mortgages on the

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<sup>243</sup>In the earlier years of EPIC, when the interests primarily consisted of model homes that were leased back to the builder, positive cash flow was generated, and those partnerships were syndicated as "income" partnerships. In the later years of operation, the Partnerships were syndicated as tax shelters.

<sup>244</sup>For example, on some of the pass-through securities sold immediately prior to EPIC's default, the first 25% of the risk was to be borne by a primary insurer, with a reinsurer bearing up to 33.3% of the excess loss.

<sup>245</sup>EPIC created "pac-man" partnerships to purchase unsold units and to subsequently syndicate them. These partnerships only delayed the problem since these too had to be sold.

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properties. When, in mid-August 1985, the savings and loan was eliminated as a funding source,<sup>246</sup> EPIC defaulted on its loans, with the partnerships being placed in bankruptcy shortly thereafter. The default resulted in extensive litigation brought by several of the mortgage insurers who unsuccessfully sought to rescind mortgage insurance coverage, claiming that the insurance was procured by fraud,<sup>247</sup> and the subsequent liquidation of the insurer that had insured the largest amount of EPIC mortgages.

The characteristics of the defaulted EPIC financings differed in significant respects from rated financings.<sup>248</sup> For example, the assets used to back the securities -- particularly the mortgages on unsold units in developments -- were very risky, and to be rated would have required a loss coverage (*i.e.*, credit enhancement) far in excess of what was actually incorporated. This risk was exacerbated because appraisals of the units were often inflated, thereby understating the loan to value ratios of the mortgages. **Also**, the mortgages were concentrated heavily in a region that was not economically diverse.<sup>249</sup>

In addition, according to one rating agency, if the later financings had been rated, their structure would have been subject to much more scrutiny, including EPIC's role as servicer. In this regard, EPIC likely would not have been permitted **to commingle** the partnerships' funds with its own.

## **IV. The Investment Company Act and Structured Finance**

### **A. Applicability of the Act**

Most, if not all, structured financings meet the definition of investment company under section 3(a) of the Investment Company Act, because they both issue securities and are primarily engaged in investing in, owning, or holding

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<sup>246</sup>In September 1985, the Maryland Deposit Insurance Fund placed the savings and loan into conservatorship, after determining that its fiscal mismanagement contributed to Maryland's 1985 savings and loan crisis.

<sup>247</sup>See *Foremost Guaranty Corp. v. Meritor Sav. Bank*, 910 F.2d 118 (4th Cir. 1990).

<sup>248</sup>Of course, ratings are not complete protection against fraud, such as was prevalent in the operation of the EPIC enterprise.

<sup>249</sup>See *EPIC Revisited*, MOODY'S STRUCTURED FINANCE RESEARCH & COMMENTARY, Mar. 1988, at 3.

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securities.<sup>250</sup> Structured financings use special purpose entities that issue debt or equity interests. In the context of the Investment Company Act, the financial instruments held by the issuers in structured financings generally have been considered to be securities.<sup>251</sup>

Because the structured finance market did not exist in 1940, the Act was not drafted to regulate or exclude structured financings. The drafters of the Act simply were attempting to devise a regulatory framework for the types of investment companies that existed at that time.<sup>252</sup>

Not surprisingly, structured financings cannot operate under the Act's requirements. For example, section 17(a) prohibits certain affiliates of registered investment companies from selling securities and other property to the investment

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<sup>250</sup>Section 3(a)(1) defines an investment company as any issuer of securities which "is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading in securities. 15 U.S.C. § 80a-3(a)(1). Section 3(a)(3) defines an investment company as any issuer of securities which "is engaged or proposes to engage in the business of investing, reinvesting, owning, holding, or trading in securities, and owns or proposes to acquire investment securities [as that term is defined in the Act] having a value exceeding 40 per centum of the value of such issuer's assets (exclusive of Government securities and cash items) on an unconsolidated basis." Almost all structured financings meet one, if not both, of these definitions. See C. Thomas Kunz, *Securities Law Considerations, in THE ASSET SECURITIZATION HANDBOOK* 347, 374 (Phillip L. Zweig ed., 1989) ("because the issuer in an asset securitization transaction (whether a grantor trust, a finance subsidiary, or an asset-backed securities issuer) issues a 'security' and holds 'receivables' of some kind, which are both 'securities' and 'investment securities' within the Investment Company Act, an exemption from compliance therewith or a 'safe-harbor' thereunder must be sought.").

<sup>251</sup>See, e.g., SEC, REPORT ON THE PUBLIC POLICY IMPLICATIONS OF INVESTMENT COMPANY GROWTH, H.R. REP. No. 2337, 89th Cong., 2d Sess. 328 (1966) [hereinafter PPI REPORT] (stating that notes representing the sales price of merchandise, loans to manufacturers, wholesalers, retailers and purchasers of merchandise or insurance, and mortgages and other interest in real estate are investment securities for purposes of the Act). See also *infra* notes 333-339 and accompanying text.

<sup>252</sup>See, e.g., *Investment Trusts and Investment Companies: Hearings on S.3580 Before a Subcomm. of the Senate Comm. on Banking and Currency*, 76th Cong., 3d Sess. 43 (1940) [hereinafter 2940 Senate Hearings] (statement of Robert E. Healy, Commissioner, SEC) ("[T]he bill does not attempt to set up an ideal form of investment company and then compel all companies to conform to the ideal. Its provisions have been scrupulously adapted to the existing diversities of investment company organizations and functions."). Although interests in pools of mortgages were sold to the public in the 1930's and in fact raised a number of investor protection concerns (see *supra* note 15), there is no indication that Congress or the Commission intended them to be covered by the Act. Section 3(c)(5)(C), discussed *infra* notes 263-269 and accompanying text, excepts many, if not most, of these issuers. See 15 U.S.C. § 80a-3(c)(5)(C).

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**company.**<sup>253</sup> In a structured financing, this section would prohibit the sponsor's sale of assets to the issuer, or any substitution of assets by the sponsor. In addition, section 18 limits management investment companies from issuing senior securities, which includes debt. These restrictions are fundamentally inconsistent with the operations of virtually all securitized credit offerings.

Thus, sponsors must find a way to avoid application of the Act. They must either structure their transactions to come within one of the statutory exceptions to the definition of investment company or seek exemptive relief from the Commission.

## **1. Statutory Exceptions**

Although section 3(c) of the Act excepts from the definition of investment company a number of issuers, only two exceptions are particularly relevant to private sector structured financings: sections 3(c)(5) and 3(c)(1).<sup>254</sup>

### **a. Section 3(c)(5)**

Many structured financings have relied on section 3(c)(5), which, as enacted in 1940 and amended in 1970, was intended to except issuers engaged primarily in the factoring, discounting, or real estate businesses.<sup>255</sup> Such activities were "generally understood not to be within the concept of a

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\*For a more detailed discussion of section 17(a), see Chapter 12.

<sup>254</sup>Other exceptions may be available for a limited number of private sector structured financings. For example, some structured financings may be able to avoid application of the Act by relying on section 3(c)(4), which excepts issuers whose businesses are substantially confined to making small loans, industrial banking, or similar businesses. In addition, some financings may be able to rely on section 3(c)(6), which pertains to holding companies of entities in the businesses described in sections 3(c)(3), 3(c)(4), and 3(c)(5). The "bad bank" financings have received bank charters and relied on section 3(c)(3). Some financings sponsored by the federal government are excepted from the Act by section 2(b). See, e.g., Cleary, Gottlieb, Steen & Hamilton (pub. avail. Jul. 18, 1991) (no-action position regarding proposed CBOs sponsored by issuers created and controlled by the RTC).

<sup>255</sup>S. REP. No. 1775, 76th Cong., 3d Sess. 13 (1940); H.R. REP. NO. 2639, 76th Cong., 3d Sess. 12 (1940); S. REP. No. 184, 91st Cong., 1st Sess. 37 (1969); H.R. Rep. No. 1382, 91st Cong., 2d Sess. 17 (1970). See also 1940 Senate Hearings, supra note 252, at 181-182 (testimony of David Schenker, Chief Counsel, SEC Investment Trust Study).

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conventional investment company which invests in stocks and bonds of corporate issuers."<sup>256</sup>

Section 3(c)(5) was added at the request of sales finance companies. By its terms, the section excepts:

[a]ny person who is not engaged in the business of issuing redeemable securities, face-amount certificates of the installment type or periodic payment plan certificates, and who is primarily engaged in one or more of the following businesses: (A) purchasing or otherwise acquiring notes, drafts; acceptances, open accounts receivable, and other obligations representing part or all of the sales price of merchandise, insurance, and services; (B) making loans to manufacturers, wholesalers, and retailers of, and to prospective purchasers of, specified merchandise, insurance, and services; and (C) purchasing or otherwise acquiring mortgages and other liens on and interests in real estate.

Thus, to be within section 3(c)(5), an issuer may not issue certain types of securities and also must be primarily engaged in one or more of the businesses enumerated in the section.

Many sponsors of structured financings have relied on section 3(c)(5) to avoid regulation under the Act. Virtually no structured financings issue redeemable securities, face-amount certificates, or periodic payment plan certificates.<sup>257</sup> (Certain other issuers are required to register under the Act

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<sup>256</sup>PPI REPORT, *supra* note 251, at 328. In 1940, the exclusion was limited to factoring, discounting and real estate businesses that did not engage in issuing face-amount certificates of the installment type or periodic payment plan certificates. This limitation was in response to the abuse found prior to 1940 in the sale of these types of securities, usually to relatively unsophisticated investors, by companies, including those of the type that would have been excluded by this provision but for the limitation. See 1940 Senate Hearings, *supra* note 252, at 182 (statement of David Schenker). In 1970, Congress amended section 3(c)(5) to prohibit the issuance of redeemable securities. The purpose of the amendment was to prevent excepted companies from capitalizing on the popularity of open-end investment companies by selling shares of redeemable securities. Investment Company Amendments Act of 1970, Pub. L. No. 91-547, § 2(a), 3(b), 84 Stat. 1413 (1970) (*codified us amended* at 15 U.S.C. §§ 80a-2(a)(32), 3(c)(5)).

<sup>257</sup>Section 2(a)(32) (15 U.S.C. § 80a-2(a)(32)), defines "redeemable security" to be "any security, other than short-term paper, under the terms of which the holder, upon its presentation to the issuer or to a person designated by the issuer, is entitled . . . to receive approximately his proportionate share of the issuer's current net assets, or the cash equivalent thereof." Numerous (continued..)

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because they issue redeemable securities, even though they invest in section 3(c)(5) assets. For example, so-called GNMA funds, *i.e.*, issuers that invest in GNMA certificates, register as open-end investment companies or unit investment trusts because they issue redeemable securities.)<sup>258</sup>

To rely on section 3(c)(5), a structured financing must be "primarily engaged" in one or more of the types of businesses described in subparagraphs (A), (B), and (C). The issues relevant to whether a structured financing comes within subparagraphs (A) or (B) differ somewhat from those relevant to whether a structured financing comes within subparagraph (C). Accordingly, we discuss subparagraphs (A) and (B) separately from subparagraph (C).

### **(1) Subparagraphs (A) & (B)**

Subparagraph (A) refers to the *purchase or other acquisition* of notes and other evidences of indebtedness representing the sales price of merchandise, insurance, and services. Subparagraph (B) refers to the *making of loans* to manufacturers, wholesalers, retailers, and prospective purchasers of specified merchandise, insurance, and services. A number of no-action letters have been issued to entities holding a wide variety of receivables, loans to refinance receivables, open accounts receivable, and loans to manufacturers of specified merchandise and services.<sup>259</sup> When the assets the entity acquires are not

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<sup>257</sup>(...continued)

no-action positions have been issued with respect to the definition of redeemable security in the context of section 3(c)(5). For example, a debt security may be a redeemable security. See G.A.B.E. Inc. (pub. avail. Feb. 15, 1974). No-action positions also have treated a security that may be presented to the issuer by the holder **as** not being a redeemable security if substantial restrictions are placed on the right of redemption. *See, e.g.*, California Dentists' Guild Real Estate Mortgage Fund II (pub. avail. Jan. 4, 1990) (restrictions included prohibiting investors from withdrawing funds during the first 12 months after purchase, after which withdrawal could occur only on a quarterly basis and with 90 days prior notice; limiting the amount an investor could withdraw; and limiting the amount available to fund withdrawals).

<sup>258</sup>Some GNMA certificates are considered to be section 3(c)(5)(C) assets. See *infra* note 267 and accompanying text.

<sup>259</sup>*See, e.g.*, Ambassador Capital Corporation (pub. avail. Oct. 6, 1986) (no-action position taken with respect to entity holding airline credit card accounts receivable); Days Inn of America, Inc. (pub. avail. Dec. 30, 1988) (no-action position taken with respect to entity holding franchise fee receivables).

Whether an issuer is "primarily engaged" in one or more of these activities for purposes of subsections (A) and (B) generally has not been an issue. But see Econo Lodges of America, Inc. (pub. avail. Dec. 22, 1989) (no-action position taken where franchise royalty fee receivables (continued..)

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related to the purchase or sale of specific merchandise, insurance, or services, the no-action request has been refused.<sup>260</sup>

Many non-mortgage structured financings, including financings backed by automobile loans, boat loans, credit card receivables, and equipment leases, among others, rely on subparagraphs (A) or (B).<sup>261</sup> All of these financings are backed by assets that relate to the purchase or sale of specified goods or services. Other financings, such as those using commercial loans, student loans, and CBOs, typically are unable to rely on these subparagraphs because their assets do not meet the criteria of subparagraphs (A) and (B).

Not all financings backed by revolving credit card accounts receivable are able to rely on subparagraph (A). Although most financings using these assets

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<sup>259</sup>(...continued)

obtained from entity's parent represented at least 55% of the entity's assets, and at least 85% of the net proceeds from the sale of notes backed by the receivables were subsequently loaned to parent). This issue, however, has been the subject of a substantial number of no-action letters in the context of section 3(c)(5)(C). See, e.g., no-action letters cited *infra* notes 263-269 and accompanying text.

<sup>260</sup>See, e.g., World Evangelical Development Ltd. (pub. avail. Apr. 5, 1979) (no-action position declined where entity would issue general purpose commercial loans); Educational Loan Marketing Associations, Inc. (pub. avail. Feb. 4, 1986) (no-action position declined where entity would issue debt secured by the repayment of student loans financed by proceeds from the debt offering).

<sup>261</sup>See Letter from Thomas R. Smith, Jr., Brown & Wood, on behalf of Merrill Lynch Capital Markets et al., to Kathryn B. McGrath, Director, Division of Investment Management, SEC 7-14 (Feb. 27, 1990), File No. S7-11-90 (arguing that credit card receivable financings are excepted from the Investment Company Act). The Investment Company Institute ("ICI") has argued that financings backed by credit card receivables are investment companies and should be regulated under the Act. The ICI has argued that section 3(c)(5) does not exempt these financings because they have little in common with traditional commercial finance companies. The ICI has also argued, among other things, that the relationships among the participants of credit card-backed financings give rise to the types of potential self-dealing and conflicts of interest concerns that the Investment Company Act is intended to address. See Letter from the ICI to Richard C. Breeden, Chairman, SEC 2 (Feb. 2, 1990), File No. S7-11-90. The ICI had previously sent a similar letter to the Division. See also Letter from Tamar Frankel, Professor of Law, Boston University, to Kathryn B. McGrath, Director, Division of Investment Management, SEC 1, 6 (Jan. 26, 1990), File No. S7-11-90 (suggesting the Commission design a regulatory system under the Act for financings backed by credit card receivables).

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have not registered as investment companies in reliance on this section, they generally have limited the percentage of their assets that consist of obligations resulting from cash advances out of concern that, since such advances are general purpose consumer loans, a significant amount of these assets could cause a financing to be outside section 3(c)(5).<sup>262</sup>

## (2) Subparagraph (C)

Many issuers of mortgage-backed securities and similar products have relied on subparagraph (C). **An** issuer seeking to rely on this exception must invest at least fifty-five percent of its assets in mortgages and other liens on and interests in real estate ("qualifying interests"). **An** additional twenty-five percent of the issuer's assets must be in real estate related assets, although this percentage may be reduced to the extent that more than fifty-five percent of the issuer's assets are invested in qualifying interests.<sup>263</sup>

A number of no-action letters have been issued explicating what are qualifying interests for purposes of subparagraph (C). These interests include fee interests,<sup>264</sup> leaseholds,<sup>265</sup> and interests fully secured by a mortgage solely on real estate ("whole mortgages")<sup>266</sup>. Qualifying interests also include agency "whole pool certificates."<sup>267</sup> The rationale is that the holder of these certificates generally has the same economic experience as the investor who purchases the underlying mortgages directly, including the receipt of both principal and interest payments and the risk of prepayment on the underlying mortgage loans, notwithstanding the guarantees provided by the agencies.

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<sup>262</sup>See Letter from Cleary, Gottlieb, Steen & Hamilton to Jonathan G. Katz, Secretary, SEC 62 (Oct. 12, 1990), File No. S7-11-90 [hereinafter Cleary, Gottlieb Study Comment].

<sup>263</sup>See, e.g., Greenwich Capital Acceptance, Inc. (pub. avail. Aug. 8, 1991); United Bankers, Inc. (pub. avail. Mar. 23, 1988). Generally, there are no restrictions on the investment of the remaining 20% of the issuer's assets. See, e.g., NAB Asset Corp. (pub. avail. June 20, 1991).

<sup>264</sup>United Bankers, Inc., *supra* note 263.

<sup>265</sup>See Health Facility Credit Corp. (pub. avail Feb. 6, 1985).

<sup>266</sup>See Medidentic Mortgage Investors (pub. avail. May 23, 1984).

<sup>267</sup>See, e.g., American Home Finance Corp. (pub. avail. Apr. 9, 1981) (GNMA certificates). The term "whole pool certificate" means a certificate that represents the entire ownership interest in a particular pool of mortgage loans. A "partial pool certificate" is a certificate that represents less than the entire ownership interest in a particular pool of mortgage loans.

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Agency partial pool certificates that represent less than the entire ownership interest in a pool of mortgages ("partial pool certificates") have not been considered to be qualifying interests.<sup>268</sup> The rationale is that an investor in partial pool certificates obtains greater diversification and is subject to a different prepayment risk than an investor who purchases the underlying mortgages directly. **An** investment in partial pool certificates is viewed as being more like an investment in the securities of the issuer, rather than an investment in the underlying mortgages. Partial pool certificates are considered to be a real estate related asset for purposes of meeting the twenty-five percent portion of the "primarily engaged in" test, however. Similarly, residual interests are not qualifying interests for purposes of subparagraph (C),<sup>269</sup> although they may be considered to be real estate related assets.

### b. Section 3(c)(1)

Many financings rely on section 3(c)(1). This section, known as the "private investment company" exception, excepts any issuer whose outstanding securities (other than short term paper) are beneficially owned by not more than 100 persons. In addition, the issuer may not make, or propose to make, a public offering.<sup>270</sup> Thus, sponsors that wish to offer publicly securitized credit in the United States cannot rely on this exception.

## 2. Exemptive Relief

Some structured financings have obtained exemptive relief from the Commission under section 6(c), the general exemptive provision of the Act.<sup>271</sup> Most of the exemptive orders concern CMOs and REMICs whose assets consist

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<sup>268</sup>See Nottingham Realty Securities, Inc. (pub. avail. Apr. 19, 1984).

<sup>269</sup>See, e.g., M.D.C. Holdings (pub. avail. May 5, 1987). While agency whole pool certificates are deemed to be qualifying interests, it is the position of the Division that whole pool (or partial pool) certificates issued by private issuers are not qualifying interests under section 3(c)(5)(C). A no-action position has not been requested regarding private residential mortgage loans held by the issuer under funding agreements (*i.e.*, promissory notes secured by mortgage loans or mortgage Certificates). Nevertheless, these assets are not generally considered to be qualifying interests for purposes of section 3(c)(5)(C). Some issuers investing primarily in partial pool certificates and other real estate related assets have received exemptive relief. See *infra* note 272 and accompanying text.

<sup>270</sup>For a more detailed discussion of section 3(c)(1), see Chapter 2.

<sup>271</sup>15 U.S.C. § 80a-6(c).

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primarily of partial pool certificates and other mortgage-related assets that are not qualifying interests under section 3(c)(5)(C).<sup>272</sup> In this regard, the legislative history of **SMMEA** indicates that Congress expected the Commission to provide appropriate administrative relief if the Investment Compan Act unnecessarily hindered development of the secondary mortgage market.<sup>273</sup> The Commission has issued approximately 125 orders under section 6(c) exempting structured financings backed by mortgage-related assets.<sup>274</sup>

In general, the orders have required, among other things, that (i) the securities be rated in the top two categories by at least one rating agency; (ii) substitution of the assets be limited quantitatively and qualitatively; (iii) the assets be held by an independent trustee, qualified under the Trust Indenture Act, who has a first priority perfected security or lien interest in the collateral; (iv) the servicer not be affiliated with the trustee; and (v) the issuer be audited annually to determine that the cash flow is sufficient for payments of principal and interest. These conditions have been imposed to ensure the safety and adequacy of the assets, to guard against self-dealing by sponsors, and to address concerns about capital structure. Many of the conditions parallel requirements imposed by the rating agencies as a condition of receiving a rating in the top two categories. The exemptive orders also have imposed conditions limiting the sale of residual interests.

Another type of structured financing that has received exemptive relief is the sale of federal government loans. Pursuant to the Omnibus Reconciliation

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<sup>272</sup>In addition to CMOs and REMICs, exemptive orders have been issued to special purpose corporations organized by home builders that wish to issue, among other things, bonds secured by pledges of mortgage loans on single family residences constructed by the builders, called "builder bonds." See, e.g., American Southwest Financial Corp., et al., Investment Company Act Release No. **12771** (Oct. 29, 1982), **47 FR 50594** (Notice of Application) and **12844** (Nov. 23, 1982), **26** SEC Docket **1251** (Order).

<sup>273</sup>See S. REP. NO. **293**, 98th Cong., 2d Sess. **9** (1983). The Senate Committee on Banking, Finance and Urban Affairs considered whether the Investment Company Act should be amended to except issuers investing in certain mortgage-backed securities from the definition of investment company, but reported legislation without such an exception in light of the Commission's administrative flexibility. *Id.*

<sup>274</sup>See, e.g., Mortgage Bankers Financial Corp. I et al., Investment Company Act Release Nos. **16458** (June 28, 1988), **53 FR 25226** (Notice of Application) and **16497** (July 25, 1988), **41** SEC Docket **814** (Order); Shearson Lehman CMO, Inc., Investment Company Act Release Nos. **15796** (June 11, 1987), **52 FR 23246** (Notice of Application) and **15852** (July 2, 1987), **38** SEC Docket **1403** (Order).

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Acts of 1986<sup>275</sup> and 1987<sup>276</sup> the federal government sold portions of the loan portfolios of certain government agencies. Most of these sales could not be completed without exemptive relief from the Investment Company Act, although some were excepted under section 3(c)(5). A total of seven financings either received exemptions under sections 6(c) and 6(e) from most provisions of the Act, including the registration requirement,<sup>277</sup> or registered as closed-end management investment companies and received exemptions from much of the Act.<sup>278</sup> The conditions imposed were similar to those for mortgage-related financings, requiring, among other things, that (i) the debt obligations be rated in at least one of the two highest rating categories; (ii) the residual interests be privately placed with a maximum of 100 sophisticated and experienced investors; and (iii) the pool of assets be fixed, except for limited substitutions.<sup>279</sup>

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<sup>275</sup>Omnibus Budget Reconciliation Act of 1986, Pub. L. No. 99-509, 100 Stat. 1874 (1986).

<sup>276</sup>Omnibus Budget Reconciliation Act of 1987, Pub. L. No. 100-203, 101 Stat. 1330 (1987). The objectives of the loan asset sales program were to reduce the government's cost of administering credit programs by transferring administrative responsibility to the private sector; improve loan origination and documentation; determine the actual subsidy of a federal credit program; and reduce the budget deficit in the year of sale. See OMB Guidelines on Loan Asset Sales, reprinted in GENERAL ACCOUNTING OFFICE, LOAN ASSET SALES: OMB POLICIES WILL RESULT IN PROGRAM OBJECTIVES NOT BEING FULLY ACHIEVED, App. II (Sept. 1986).

<sup>277</sup>Generally, the issuer agreed to be subject to section 26 (15 U.S.C. § 80a-26) (with certain exceptions), which applies to unit investment trusts; section 36 (15 U.S.C. § 80a-35), which subjects certain affiliated persons of an investment company, including a depositor of a unit investment trust, to liability for breaches of fiduciary duty involving personal misconduct; section 37 (15 U.S.C. § 80a-36), which makes it a crime for any person to steal or embezzle any funds or assets of a registered investment company; and sections 38 through 53 (15 U.S.C. §§ 80a-37 to -52) (often referred to as the "jurisdictional" sections of the Act) to the extent necessary to enforce compliance with sections 26, 36, and 37.

<sup>278</sup>Some issuers registered as investment companies because of tax advantages. See, e.g., College and University Facility Loan Trust, Investment Company Act Release Nos. 15903 (July 31, 1987), 52 FR 28890 (Notice of Application) and 15990 (Sept. 18, 1987), 39 SEC Docket 348 (Order).

<sup>279</sup>The only other exemptive order issued by the Commission with respect to structured financings involved trusts established by the Government of Israel to facilitate the financing of its housing program for Soviet refugees. Each trust was to issue non-redeemable pass-through certificates backed by a single promissory note, the payment of which would be guaranteed by the full faith and credit of the United States. See Government of Israel, Investment Company Act Release Nos. 18047 (Mar. 18, 1991), 56 FR 11806 (Notice of Application) and 18069 (Mar. 28, 1991), 48 SEC Docket 943 (Order).

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## **B. Effects of the Regulatory Structure**

As a practical matter, the Act today treats similar types of structured financings very differently. Some structured financings are subject to prohibitive conditions imposed by the Act, while others are exempted from the Act entirely.

Structured financings that are excepted by section 3(c)(5) or that have obtained exemptions may be sold publicly or privately in the United States, overseas, or both. Financings that do not fit within section 3(c)(5) or that are unable to obtain an exemption either must be privately placed in the United States or sold overseas. Each may be problematic for the sponsor. For example, private placements prevent sponsors from diversifying and expanding their investor bases and ensuring a liquid secondary market for the securities. The success of international offerings has been mixed.

The differing regulatory treatment affects the development of the structured finance market. The most widely accepted types of structured financings are those that are sold on the domestic public market, while those structured financings whose distribution is limited to private placements or overseas offerings have lagged in development. Many United States investors that may wish to purchase these securities are prohibited from doing so, even though the securities may be highly rated by a rating agency, because the securities are not offered publicly. Thus, today the Act distorts the market by enforcing a distinction that does not reflect the economic reality that any asset with a relatively predictable cash flow, whether it may be classified as a "commercial" instrument or a "financial" instrument, may be securitized.

The attempt by market participants to fit financings into section 3(c)(5) is understandable, but unproductive, consuming much time of sponsors, underwriters, and their counsel, as well as the time of the Commission and its staff. A preferable alternative is to develop a coherent approach to the treatment of structured financings under the Investment Company Act. Such an approach must take into account the unique operation of the industry and also address any investor protection concerns resulting from the pooling of securities.

## **V. The Reform of the Treatment of Structured Finance**

In determining how the Investment Company Act should treat private sector structured finance, it is important to recognize that the purpose of structured finance is quite different from that of most investment companies. Structured finance primarily is a financing technique that integrates the capital

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markets with borrowers seeking access to those markets; the sponsors of asset securitizations are seeking a source of financing. In contrast, investment companies are intended to provide the advantages of professional management, diversification, and economies of scale to investors.

Nevertheless, the fundamental issue is whether structured financings in fact present opportunities for abuse similar to those presented by registered investment companies. We conclude that all structured financings, regardless of the nature of their underlying assets, theoretically present the opportunities for abuses similar to those that led to the enactment of the Investment Company Act. The industry, however, has been remarkably free of abusive practices, due primarily to the requirements thus far imposed by the market itself.

Based on this record, we recommend that the Commission adopt an exemptive rule to permit all structured financings to offer their securities publicly in the United States without registering under the Investment Company Act, provided that the financings meet certain conditions that would codify present industry practice. The conditions would limit the scope of the rule to issuers that invest in assets that have scheduled cash flows; primarily hold the assets to maturity (*i.e.*, have limited portfolio management); issue nonredeemable securities; issue publicly only debt or debt-like securities rated in the top two investment grades, the payment of which depends on the cash flows of the underlying assets; and whose assets are held by a qualified trustee. In addition, we recommend that the Commission seek public comment on whether section 3(c)(5) should be amended so that all structured financings are subject to the same requirements for exemption.

In this section, we analyze the potential for abuse in structured financings in light of the structural and operational differences between investment companies and structured financings, the actual experience over the last two decades, options for rationalizing the treatment of structured finance under the Act, and the outlines of the exemptive rule we recommend. We also discuss whether section 3(c)(5) should be amended.

### **A. The Potential for Abuse in Structured Financings**

Because structured financings have some of the principal features of registered investment companies -- that is, they are issuers of securities and hold pooled financial assets -- the key question is whether those financings share with traditional investment companies the potential for the types of abuses that led to the enactment of the Investment Company Act. These abuses include

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opportunities for self-dealing and overreaching by insiders, inaccurate valuation of assets, excessive leverage, and inadequate protection of assets.

## **1. Overreaching and Self-Dealing by Insiders**

One of the most significant concerns addressed by the Investment Company Act is overreaching and self-dealing by investment company insiders. The Commission's 1940 Investment Trust Study documented numerous instances in which investment companies were managed for the benefit of their sponsors and affiliates to the detriment of investors. For example, the "dumping" by sponsors of worthless or unmarketable securities into investment companies was prevalent. Accordingly, the Act and the rules thereunder prohibit or restrict most transactions with insiders.<sup>280</sup>

Structured financings present a number of opportunities for analogous forms of self-dealing and overreaching. For example, a sponsor could engage in a form of dumping by selling to a special purpose issuer assets of insufficient credit quality and amount to produce adequate cash flows to make full and timely payment on the fixed income securities sold to the public.<sup>281</sup>

Self-dealing and overreaching by insiders after the initial deposit of assets also could harm investors. For example, a sponsor could substitute inferior assets for the assets originally placed in the pool, thereby jeopardizing payments to investors. In the case of structured financings backed by revolving credit card receivables and asset-backed commercial paper programs, similar abuses could arise, because a sponsor may sell additional assets to the issuer after the financing first offers securities to the public.

In addition, the servicer often reinvests idle cash in short-term investments when there is a timing mismatch between the collections from the underlying assets, and distributions to investors.<sup>282</sup> Absent appropriate restrictions, a servicer, particularly if it is the sponsor or an affiliate, might reinvest the cash in

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<sup>280</sup>See Chapter 12.

<sup>281</sup>Of course, section 17(a) (15 U.S.C. § 80a-17(a)), the Investment Company Act's prohibition on principal transactions with insiders, does not apply to the initial deposit of securities into a UIT, a transaction which is analogous to the transfer of assets to a special purpose issuer in a structured financing.

<sup>282</sup>See supra note 112 and accompanying text.

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the sponsor's own risky securities, thereby benefitting the sponsor at the expense of investors, should the sponsor default.

Finally, the potential for other types of self-dealing exist where the sponsor or its affiliate acts as servicer. Perhaps the most serious type is where the sponsor/servicer has other dealings with the obligors on the assets in the pools, which decrease its incentive to service the debt properly.<sup>283</sup> For example, in a structured financing backed by credit card accounts receivable, the sponsor owns the accounts from which the receivables are generated and typically continues to service them through and beyond the course of the financing. If the sponsor is also a retailer, it may alter the accounts' terms (e.g., interest rate charged, credit limit, minimum payment schedule), in order to generate additional receivables from the accounts, or to preserve its relationship with its customers. Because the receivables generated from the accounts are continually sold to the issuer during the "interest only" period of the transaction,<sup>284</sup> the amended terms could prevent timely payment to investors. Also, in acting as servicer, the sponsor may commingle collections on the assets with its own funds, thereby subjecting investors to the risk of the sponsor's insolvency.

On the other hand, the nature of the securities issued in most structured financings alters and to some extent reduces the concerns about self-dealing. Losses on the assets in the pool are borne first by parties other than fixed-income investors, such as the holder of the residual interest and the servicer.<sup>285</sup> Thus, self-dealing affects fixed-income investors only to the extent it completely erodes the cash flow cushion provided by those with more junior interests in the pool.

## 2. Inaccurate Valuation of Assets

Before 1940, investment companies often valued their portfolios inaccurately, resulting in unfair and discriminatory practices in the pricing of their securities. The Act now generally requires that investment companies value their assets at market value.

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<sup>283</sup>Of course, for many financings, the fact that the sponsor services the assets is desirable because the sponsor is familiar not only with the type of business from which the underlying assets were generated, but also with many of the characteristics of the specific assets.

<sup>284</sup>See *supra* note 157 and accompanying text.

<sup>285</sup>Because the holders of residual interests are almost invariably sophisticated institutional investors, they presumably are able to evaluate the risk of self-dealing, inaccurate valuation of assets, excessive leverage, and inadequate protection of assets.

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In a structured financing, the valuation of the assets (albeit on a cash flow basis) is critical because payments on the fixed-income securities sold to public investors depend primarily or entirely on those assets. Because structured financings primarily issue unredeemable fixed-income securities whose payment is derived solely or primarily from the cash flow on the underlying assets, and are evaluated by investors and others on that basis, continuous valuation of assets on a market value basis is not as critical. Arguably, however, the sponsor may misvalue assets used in structured financings, resulting in a structured finance issuer holding assets whose cash flow has little relationship to the securities issued in the financing.

### **3. Excessive Leverage**

Prior to 1940, some investment companies were highly leveraged, issuing large amounts of "senior securities," in the form of debt or preferred stock. This often resulted in the companies being unable to meet their obligations to the holders of these securities. This risk was exacerbated when equity holders redeemed their shares. Excessive issuance of senior securities also greatly increased the speculative nature of the common stock of the companies. In response, the Act limits the issuance of senior securities by management investment companies.<sup>286</sup>

In theory, leverage concerns are somewhat applicable to structured financings, given the degree of leverage used in virtually all structured financings. Financings could be established with assets that would not produce the cash flows needed to meet the obligations to the investors of the fixed-income securities. The effect of leverage on residual interest holders in structured financings is not truly an Investment Company Act concern, however, since those investors invariably are extremely sophisticated investors, not the type of investor the Act was intended to protect.<sup>287</sup> Moreover, because structured financings do not issue redeemable securities, there is no threat of redemption or repurchases of equity that could endanger senior security holders.

### **4. Protection of Assets**

In numerous instances prior to 1940, the assets of investment companies were not adequately protected. In many cases, controlling persons of investment

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<sup>286</sup>See Investment Company Act § 18/15 U.S.C. § 80a-18. For a general discussion of the Act's limits on leverage, see Chapter 11.

<sup>287</sup>There is no requirement that residual investors be sophisticated, however.

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companies commingled the investment company's assets with the investment adviser's, and then proceeded to take the assets on loan.<sup>288</sup> Accordingly, the Act requires that investment company assets be held by qualified custodians.<sup>289</sup>

The assets of a structured financing also may be subject to risk, absent the imposition of adequate safeguards. For example, the servicer could commingle collections with its own funds and then use them in such a manner as to jeopardize their availability to pay investors. The insolvency of the servicer also could affect payment to investors.

## B. The Lack of Abuse in Structured Financings

Although structured financings present opportunities for abuses analogous to those that led to the enactment of the Investment Company Act, the Division is aware of only one case of abuse, despite the large volume of securitized transactions in the last decade.<sup>290</sup> The relative lack of abuse appears to result from the interplay of three factors.

The first factor is that most issues have been sold to institutional investors with a high degree of financial sophistication. Such investors often conduct their own due diligence reviews prior to investing and are involved in the structuring of the financing.<sup>291</sup>

The second factor is that most structured financings, and virtually all that have been offered publicly, have contained at least one class of highly rated securities.<sup>292</sup> In order for a financing to obtain a high rating, the rating agencies have required that it be structured to minimize the chance that investors in the rated securities will receive less than full and timely payment. Although the rating agencies' requirements are intended to reduce the credit risk of a structured financing, many of them have the added effect of protecting investors from the types of abuses discussed above.

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<sup>288</sup>See, e.g., 2940 Senate Hearings, *supra* note 252, at 89 (statement of Carl S. Stern, Attorney, SEC).

<sup>289</sup>See Investment Company Act § 17(f) (15 U.S.C. § 80a-17(f)), and rules 17f-1, 17f-2, 17f-3, 17f-4, and 17f-5 (17 C.F.R. §§ 270.17f-1, .17f-2, .17f-3, .17f-4, and .17f-5).

<sup>290</sup>See *supra* notes 241-249 and accompanying text for a discussion of the EPIC defaults.

<sup>291</sup>See *supra* note 74 and accompanying text.

<sup>292</sup>See *supra* note 188 and accompanying text.

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For example, the rating agencies require that the sponsor of a financing sell to the issuer assets of sufficient amount and credit quality to produce adequate cash flows to pay principal and interest on the fixed-income securities being rated. Thus, they either review the specific assets to be deposited, or the method by which they will be selected, and typically require safeguards such as independent auditor confirmation that the selection is random. In addition, the rating agencies impose limitations on the substitution of assets in the pool, the reinvestment of cash flows, and servicing decisions. These requirements protect investors from self-dealing and overreaching by sponsors.

The rating agencies also address concerns related to the valuation of assets. In order to determine whether the pooled assets will produce the necessary cash flows, the rating agencies, among other things, use an actuarial or statistical analysis to make generalized assumptions about the pool's performance, as it relates to the scheduled principal and interest payment on the rated securities and any other debt issued.<sup>293</sup> This analysis is fundamentally an assessment of the degree of leverage of the issuer.

Finally, the rating agencies impose requirements that are intended to ensure the safety of a financing's assets. They have developed criteria to address concerns that the assets would be jeopardized in the event of the sponsor's insolvency.<sup>294</sup> In addition, the rating agencies generally prohibit the servicer from commingling the underlying cash flows with its own funds unless the servicer is rated as high as the fixed-income securities. They also may require that a trustee hold the assets in an account in trust for the benefit of the investors in the transaction.<sup>295</sup>

The third factor that appears to have prevented abuses is that most sponsors of structured financings have been large, well-known companies. These entities have an interest in ensuring that their financings are structured and operated properly, in part because any problems associated with an offering will affect their ability to offer other financings in the future. For the sponsors, the financings are a critical means to address their capital needs. In addition, sponsoring a financing that defaults could adversely affect a sponsor's public

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<sup>293</sup>See *supra* notes 212,220-221 and accompanying text.

<sup>294</sup>See *supra* notes 196-206 and accompanying text.

<sup>295</sup>See S&P's STRUCTURED FINANCE CRITERIA, *supra* note 108, at 23-24. The involvement of the rating agencies also alleviates to a large extent any concerns regarding the complex capital structures of structured financings. Investor confusion resulting from complex capital structures was one of the concerns that led to the enactment of section 18 of the Act.

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image.<sup>296</sup> We note, however, that this third factor appears to be much less important than the other two, since many structured financings have been sponsored by depository institutions that subsequently were declared insolvent. None of these financings has suffered a default.<sup>297</sup>

### C. Recommendation -- An Exemptive Rule

Reforming the treatment of structured finance under the Investment Company Act initially presents two choices. Structured financings could be considered investment companies and required to register and comply with a set of provisions specially tailored for the structured finance industry. Alternatively, structured financings could be exempted under conditions that serve both to draw lines of demarcation between traditional investment companies and structured financings and to ensure that structured financings continue to be free of abuse.

Because the structured finance industry has been virtually free of abuse, we recommend against attempting to bring all structured financings under the Investment Company Act. It is difficult and probably futile to attempt to address any investor protection concerns that have not yet arisen. The drafters of the Investment Company Act had as their inspiration the problems that plagued the investment company industry in the 1920's and 1930's. Fortunately, the structured finance industry has not presented such problems.

Just as important, any attempt to apply even a limited array of the Act's provisions is likely to disrupt an increasingly important form of finance, depriving investors of attractive, low risk investments and foreclosing low cost borrowing for businesses. For example, the Investment Company Institute ("ICI") has submitted a proposal to regulate structured financings as essentially unit investment trusts that issue only unredeemable securities (including debt).<sup>298</sup> While the proposal addresses some of the problems structured financings would face in attempting to comply with the Act, such as the Act's limits on leverage,

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<sup>296</sup>Sponsors also often retain some form of economic interest in the financing after issuance, either by providing recourse, acting as servicer (whose fee is typically a percentage of cash flow), or retaining the residual interest or subordinate securities. Thus, any losses from overreaching or other abuses typically will affect the sponsors, providers of external credit enhancements, or sophisticated investors first.

<sup>297</sup>See *supra* note 206 and accompanying text.

<sup>298</sup>See Memorandum from the Investment Company Institute on the Regulation of Asset-Backed Arrangements under the Investment Company Act (undated), File S7-11-90 [hereinafter ICI Memorandum].

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it nevertheless would prohibit a number of practices that have not, to date, harmed investors.

For example, the proposal would limit reinvestment of cash proceeds to short-term government securities and cash items. While this would prevent possible abuses, it would also reduce returns to investors by prohibiting short-term reinvestment in highly rated commercial paper and similar, relatively low risk investments.

The proposal also would subject structured financings to the Act's restrictions on joint transactions with affiliates. Some of the mechanisms that have been created to strengthen structured financings likely would be prohibited by those restrictions. For example, spread accounts in which excess cash flow is used as a credit support might be prohibited, since both the issuer and the sponsor have an interest in the cash flow from that account.<sup>299</sup>

In addition, the proposal would subject structured financings to the Act's restrictions on distributions of long-term capital gains.<sup>300</sup> While these restrictions are appropriate for registered investment companies, since they reduce the possibility that equity investors may be led to believe that capital gain income will be regular, they are not needed to protect investors in fixed-income securities and actually could prevent timely payment of principal and interest.

Finally, the proposal would require that a pool be entirely fixed at inception, with only limited exceptions. Thus, it would prohibit some of the newer generation of structured financings, such as credit card master trusts and asset-backed commercial paper programs which, although they are not truly "managed" in the sense that management investment companies are, undergo some degree of change in the composition of their assets. It would also prohibit CBOs, since most of these structures provide for limited discretionary management of the pool.<sup>301</sup> While we agree that structured financings should not engage in asset management to the same degree as a typical open-end or

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<sup>299</sup>The proposal also would subject structured financings to section 17(a) of the Act, which prohibits principal transactions with affiliates, except for the initial deposit of assets and limited substitutions. *Id.* Thus, it would prohibit short-term reinvestment in a sponsor's commercial paper or in reverse repurchase agreements with the sponsor. Rating agencies have not objected to such transactions, if sufficient safeguards are present (e.g., commercial paper investments are permitted where the sponsor is rated as highly as the financing).

<sup>300</sup>Investment Company Act § 19(b), 15 U.S.C. § 80a-19(b).

<sup>301</sup>See *supra* note 163 and accompanying text.

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closed-end investment company, we do not believe that the strict limits of the ICI proposal are necessary.

Moreover, regulation under the Investment Company Act is likely to stifle innovation in structured finance. In just the last few years, the market has gone through a number of evolutionary changes that have benefited investors. Originally, most financings used a simple pass-through payment structure, but investors expressed concern over uncertain maturities and prepayment risk. Sponsors, underwriters, and rating agencies have designed a number of mechanisms to respond to these concerns, including multi-class structures, retention by the sponsor of an interest that absorbs the prepayment risk, short-term reinvestment of proceeds, the addition of new assets during the life of a financing, and master trusts. Designing a regulatory approach that does not inadvertently prevent or interfere with future development of the market would be extremely difficult.

For these reasons, we believe that the Commission should exempt all structured financings from the definition of investment company, subject to a number of conditions that would properly delineate the operational distinctions between investment companies and structured financings, address the investor protection concerns that could arise in this market, and accommodate future innovation. The Division recommends that the Commission promulgate a rule under the Investment Company Act to exempt all structured financings that meet the following conditions:

- (1) the issuer holds only "eligible assets," which would be defined to include assets that require regularly scheduled cash payments, such as notes, bonds, debentures, evidences of indebtedness, certificates of deposit, leases, installment contracts, interest rate swaps, repurchase agreements, guaranteed investment agreements, accounts receivable, chattel paper, cumulative preferred stock, guarantees, annuities, and participations or beneficial ownership interests in any of the foregoing;
- (2) the issuer primarily holds the assets to maturity or for the life of the issuer and does not acquire assets for the purpose of generating income from the trading or resale thereof or from the appreciation in value thereof;
- (3) the issuer does not issue any redeemable securities;
- (4) all securities offered and sold to the issuer to persons other than affiliates of the issuer or qualified institutional buyers, as defined in rule

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**144A under the Securities Act:**<sup>302</sup>

(a) entitle the holder to receive:

- (i) a stated principal amount and either (A) interest based on such principal amount calculated by reference to a fixed rate, a floating rate determined periodically by reference to an index that is generally recognized in financial markets as a reference rate of interest, or a rate or rates determined through periodic auctions among holders and prospective holders or through periodic remarketing of the security, or (B) an amount equal to specified portions of the interest received on the assets held by the issuer;
- (ii) a stated principal amount at maturity and no interest payments; or
- (iii) interest payments only, based on a notional or stated principal amount and determined in the manner described in clauses (i)(A) or (B);

(b) at the time of issuance are rated in one of the two highest grade debt rating categories by at least one nationally recognized statistical rating organization that is not affiliated with the issuer; and

(c) entitle the holder to receive payments that depend on the cash flow from the assets in paragraph (1) and that do not depend on the market value of those assets; and

(5) the issuer's assets are held by a trustee that meets the requirements of section 26(a)(1) of the Act, that is not affiliated with the issuer, and that executes an agreement concerning the securities described in paragraph (4) containing provisions to the effect set forth in sections 26(a)(3) and 26(a)(4) of the Act.

We believe that the conditions of the proposed rule would draw a clear dividing line between structured financings and investment companies that are required to register under the Act. At the same time, by codifying existing practices, the proposed rule would minimize the potential for the types of abuses

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<sup>302</sup>17 C.F.R. § 230.144A.

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addressed by the Investment Company Act, without limiting existing practices that have not harmed investors. It also should permit the continued evolution of structured financings. For example, it would permit the establishment of continuous structures and structures with differing underlying assets. All structured financings, regardless of their assets, should be able to rely on this exemption.<sup>303</sup>

We now discuss each of the major requirements of the proposed rule. Many of the details of the rule would be refined in the notice and comment process.

### **1. Eligible Assets**

The definition of eligible assets is intended to encompass all financial assets that produce regular cash flow and thus could be used in a structured financing. In other words, the only limitation is that the assets have a regularly scheduled cash flow of the type that may be statistically analyzed by rating agencies and investors. Common stock and similar equity instruments would not be eligible assets.

Obviously, this would be a substantial departure from the current practice under the Investment Company Act. Today, the Act exempts structured financings based on the type of assets held and not on their structure. The rule would recognize that the ability to use an asset successfully in a structured financing turns on whether it has a relatively predictable cash flow.

### **2. Holding Assets to Maturity**

This condition is intended to limit the amount of "management" permitted in a structured financing, while allowing enough flexibility to accommodate some of the recent innovations in the market. We have considered a number of different ways to articulate the limits on the adjustment of a financing's portfolio.

For example, one commenter responding to the Study Release<sup>304</sup> suggested requiring that an exempt financing have a fixed portfolio, with assets being removed and new assets being added only where assets are in default or in imminent danger of default, where assets do not conform to the representations

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<sup>303</sup>Most commenters advocated an exemptive rule similar to the one we recommend. See, e.g., Cleary, Gottlieb Study Comment, *supra* note 262, at App. A.

<sup>304</sup>Study Release, *supra* note 12.

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and warranties made in good faith by the sponsor, or where necessary to wind up the affairs of the issuer.<sup>305</sup> Another commenter suggested simply limiting substitutions of assets by requiring that the substituted assets be of the same general type as the original assets and not aggregate more than forty percent of the amount of assets deposited.<sup>306</sup> A third suggested allowing a greater degree of substitution, limiting it only by the requirement that the issuer not acquire assets for the purpose of generating profits from the trading or resale thereof or appreciation in the value thereof.<sup>307</sup> All of these alternatives attempt to draw a line between structured financings and typical management investment companies with regard to the degree of "management" of assets.

Drawing this line is complicated somewhat by the increase in the number of financings that do not have a fixed pool. Today, most structured financings, regardless of the nature of their assets, have some limited degree of "management" with respect to substitution of assets, reinvestment of proceeds, and, of course, servicing, but the amount of discretion in the servicer or manager varies greatly among financings depending on the terms of the transaction and on the assets being securitized.<sup>308</sup> It is apparent that the structured finance market is developing structures that have ever more flexibility in the selection of assets, such as the master trust format for credit card receivables and asset-backed commercial paper programs. Both involve issuers that continuously purchase assets and issue securities. These structures have advantages over more traditional structured financings in that, among other things, they permit sponsors

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<sup>305</sup>See *id.* Merrill Lynch suggested that if new assets are substituted for assets originally held by the issuer, the new assets must be of the same type as the assets originally held, including the same maturity and coupon, of at least the same quality as such original assets held, and insured or guaranteed to the same extent as the original assets. Letter from Merrill Lynch & Co., Inc. to Jonathan G. Katz, Secretary, SEC IX-16 (Oct. 18, 1990), File No. S7-11-90 [hereinafter Merrill Lynch Study Comment].

<sup>306</sup>See Letter from the American Bar Association, Section of Business Law, 1940 Act Structured Finance **Task Force** to Jonathan G. Katz, Secretary, SEC 14-15 (Oct. 16, 1990), File No. S7-11-90 [hereinafter Structured Finance **Task Force** Study Comment].

<sup>307</sup>See Letter from Citicorp to Jonathan G. Katz, Secretary, SEC 11 (Oct. 10, 1990), File No. S7-11-90 [hereinafter Citicorp Study Comment].

<sup>308</sup>For example, because the balance of pooled credit card receivables will fluctuate over time, financings backed by these assets often are structured to permit the sponsor to assign receivables from other accounts to the pool if the originally designated accounts do not generate enough receivables to support the securities. Similarly, because of the volatility and low credit quality of high yield bonds, financings using these assets are structured so that the bonds may be traded to prevent the deterioration of the pool, although typically the anticipated degree of management and trading is much less than that of a high yield bond fund.

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to securitize assets without the cost of establishing new structures for each offering. They also reduce prepayment risk.<sup>309</sup> Accordingly, it is foreseeable that more of these types of financings will be used in the future.

Nevertheless, structured financings do not involve management to the same degree or for the same purpose as do management investment companies. Even in a CBO offering, where the manager may have some discretion to sell bonds of issuers that may soon default or bonds that have appreciated greatly and buy new bonds, investors choose to invest based primarily on the expected cash flows from the assets initially deposited, not on the trading expertise of the manager.<sup>310</sup>

We believe that the increase in financings involving changing pools of assets necessitates imposing a condition that permits additions to the assets in the pool, but ensures that an exempt financing is not in fact managed in the same manner as a typical investment company. Preliminarily, we recommend requiring that the issuer primarily hold its assets until their maturity or for the life of the issuer and not acquire them for the purpose of trading them for profit. This will provide a standard that accommodates a limited degree of discretion as is common presently in structured financings, but ensures that exempted issuers are not in fact truly management investment companies.<sup>311</sup> Given the importance of this condition and wide range of suggestions made by commenters responding to the Study Release,<sup>312</sup> however, we recommend that the Commission specifically request comment on this point.

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<sup>309</sup>See supra text following note 176.

<sup>310</sup>See Letter from Edward F. Greene to Thomas S. Harman, SEC 14 (Dec. 16, 1991), Equitable Capital Management Corp. (pub. avail. Jan 6, 1992) ("Who the collateral manager is does not influence investors' perceptions of the risk/return characteristics of an investment in a particular CBO nearly to as great an extent as with actively managed pooled investment vehicles, because investors are not relying predominantly on the investment adviser's ability and expertise to trade the securities in the portfolio.").

<sup>311</sup>As discussed in Section V.C.4. below, we also recommend including a condition to the exemption requiring that the securities sold to the general public be rated in at least one of the top two investment grades. We expect that rating agencies will evaluate closely the degree of discretion given to the manager or servicer of the issuer's assets.

<sup>312</sup>Study Release, supra note 12.

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### **3. Prohibition on the Issuance of Redeemable Securities**

Like most of the other conditions, this condition would codify industry practice. In addition, it would ensure that no exempted issuer behaves like an open-end investment company, which could lead to investor confusion. It would also prevent junior security holders from redeeming their interests, thereby endangering payment to public investors.

### **4. The Securities Issued to the Public**

The fourth condition relates to the nature of the securities issued in the financings. It has three related requirements: all of the issuer's securities sold to public investors must be fixed-income securities; all of these securities must be rated in one of the two highest investment grade categories; and payment on the securities must be derived from the cash flow on the assets in the pool.

The first requirement would codify present practice by recognizing that structured financings almost invariably issue debt or debt-like securities. Such securities are very different from the equity interests sold by most registered investment companies.<sup>313</sup> The rule is intended to give issuers a great deal of flexibility in choosing the type of fixed-income security to be issued. For example, it would allow the issuance of principal-only or interest-only securities.

We recommend that the Commission specifically request comment on whether the rule should permit the public sale of IO and PO certificates, because of their volatility and complexity? • • While we do not wish to impose, in effect, investor suitability requirements, one of the Act's concerns is complex capital structures. At least arguably, IO and PO certificates raise similar concerns.<sup>315</sup>

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<sup>313</sup>UITs may not issue debt or senior equity securities. See 15 U.S.C. § 4(2). Open-end management investment companies may not issue senior securities, except that they may borrow from banks as long as they have 300% asset coverage. Investment Company Act § 18(f)(1), 15 U.S.C. § 80a-18(f)(1). Closed-end management investment companies may issue debt and senior equity, but must have 300% asset coverage for debt and 200% asset coverage for senior equity. Investment Company Act § 18(a), 15 U.S.C. § 80a-18(a). While face-amount certificate companies primarily issue debt securities, there are only two such issuers registered with the Commission.

<sup>314</sup>Two commenters suggested that sales of IO certificates should be restricted because of their extreme volatility. See Cleary, Gottlieb Study Comment, *supra* note 262, at 73; Merrill Lynch Study Comment, *supra* note 305, at 9-13. PO certificates also are volatile.

<sup>315</sup>We note that the ICI's proposal would not restrict the capital structure of structured financings, since it would permit a registered financing to offer any combination of debt and equity securities. ICI Memorandum, *supra* note 298, at 2.

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The second requirement, that all publicly offered fixed-income securities be rated in one of the two highest investment grades by a rating agency, also generally codifies present practice.<sup>316</sup> Virtually all structured financings have sold only rated securities publicly; most publicly offered securities have been rated in one of the top two categories. Securities that are not so rated or are unrated at all (*e.g.*, residual interests) could be sold only to qualified institutional buyers, as defined in rule 144A, or affiliates of the issuer. We believe it would be appropriate to request comment on whether the rule should require restrictions on resale of residual interests and similar securities.

This requirement would ensure that every structured financing sold to the public is subject to the scrutiny of at least one rating agency. It would rely on the agencies to continue to impose requirements that prevent self-dealing and overreaching, misvaluation of assets, and inadequate asset coverage. We believe it is appropriate to rely on the rating agencies in light of the outstanding record of rated financings. We appreciate the concerns expressed by the ICI that relying on rating agencies is inappropriate because they are private organizations whose sole function is to give opinions as to the credit quality of certain securities,<sup>317</sup> but believe that the benefits, particularly in light of the agencies' past performance in rating structured financings, are obvious, while the concerns are theoretical at best.

For example, today virtually all publicly-offered financings are rated in one of the top two investment grade ratings. Thus, the rule simply would take advantage of the role played today by the agencies and is not likely to distort the agencies' decision-making processes.

We believe also that the process of analyzing the sufficiency of the cash flow from particular assets is uniquely suited for the statistical methodology used by rating agencies to evaluate structured financings. We do not suggest that the agencies are infallible and that in the future every highly rated financing will be completely free of abuse. Nevertheless, to the Division's knowledge, no rated structured financing has defaulted on payments and relatively few have been downgraded.<sup>318</sup> We conclude that relying on the agencies will provide a very

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<sup>316</sup>We recommend using the term "nationally recognized statistical rating organization," which is used in a number of other instances in the federal securities laws. See *infra* note 319.

<sup>317</sup>See ICI Memorandum, *supra* note 298, at 2 ("The Institute does not believe that it is the function of the federal securities laws to regulate the public distribution of securities based on 'quality standards', whether determined by the SEC or private rating agencies.").

<sup>318</sup>See *supra* notes 236-237 and accompanying text.

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high degree of protection against abuses. Of course, even if the Commission were to attempt to regulate structured financings under the Investment Company Act, not all abuses would be prevented.

Further, reliance on the rating agencies as an element of the regulation of the securities markets is far from novel. Ratings first were used in 1975 in rule 15c3-1 under the Exchange Act. Today, ratings play a role in at least eleven separate provisions in the federal securities laws and rules.<sup>319</sup> In addition, ratings are used in a number of instances in federal banking law and in the securities laws of other nations.<sup>320</sup> In fact, France requires ratings for all structured financings.<sup>321</sup> Moreover, the Commission has already issued more than 100 orders exempting mortgage-related asset-backed securities financings and government loan sales from the Act, conditioned on, among other things, ratings in one of the top two investment grades.<sup>322</sup> We are not aware of any abuses in those financings or any indication that the orders somehow have interfered with the rating process.

Finally, while adoption of another rule relying on rating agencies may heighten concern over their unregulated status, we do not believe it should delay adoption of an exemptive rule for structured financings.

Although under this second requirement publicly offered securities would need to be rated in one of the top two investment grades, the Commission ultimately may decide to require only investment grade ratings. Many commenters suggested that the securities receive a rating in one of the top two

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<sup>319</sup>Section 3(a)(41) of the Exchange Act, 15 U.S.C. § 78c(a)(41); Securities Act rules 415, 436, 17 C.F.R. §§ 230.415, 436; General Instructions to Forms S-3, F-2, and F-3/17 C.F.R. §§ 239.13, 31, and 32; Exchange Act rules 10b-6 and 15c3-1, 17 C.F.R. §§ 240.10b-6 and 15c3-1; Investment Company Act rules 2a-7, 10f-3, and 12d3-1; 17 C.F.R. §§ 270.2a-7, 10f-3, and 12d3-1.

<sup>320</sup>See Neil D. Baron, *Statutory and Regulatory Uses of Ratings in the United States and other Jurisdictions* (Jan. 30, 1989).

<sup>321</sup>See French Asset-Backed Criteria, STANDARD & POOR'S CREDIT REVIEW: STRUCTURED FINANCE, June 1990, at 26.

<sup>322</sup>See *supra* notes 275 & 279 and accompanying text.

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categories, thereby in effect codifying the present market requirement.<sup>323</sup> Some commenters, however, favored requiring only investment grade ratings.<sup>324</sup>

The third requirement of this condition would limit the availability<sup>i</sup> of the exemption to those financings that issue securities whose payment depends on the cash flows generated by the income-producing assets in the underlying pool. This criteria is intended to limit the scope of the rule to the predominate types of structured financings that are currently being offered, rather than the few "market value" financings that have been offered. Thus, financings using a market value structure, where payment of the securities is derived from the aggregate market value, would not be exempted from the rule. Such transactions raise issues that differ from those financings utilizing the cash flow structure. Although this structure has been used in the past, primarily to securitize high yield bonds, its popularity has diminished significantly, and accordingly, we do not believe this limitation will significantly affect the structured finance market. Of course, financings wishing to use the market value structure could still be sold in private placements or overseas, or seek exemptive relief.

## **5. Independent Trustee**

The rule would require, in part, that all of the issuer's assets not needed for servicing be held in a segregated account by a qualified trustee or custodian for the benefit of the investors. Accordingly, all property of the pool at the time of issuance would be deposited with the trustee. This provision is intended to mitigate the concerns relating to the protection of assets. It also would require that the trustee execute an agreement providing that it shall not resign until the financing has been completely liquidated or until a successor trustee has been designated, and providing that records be kept of the security holders of the issuers. These requirements generally would codify industry practice.

This condition would not specify the other duties of the trustee. Thus, it would not address the other aspect of the role of the trustee in a structured financing: monitoring the issuer's obligation to investors and acting to protect the

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<sup>323</sup>See, e.g., Letter from Financial Security Assurance Inc. to Jonathan G. Katz, Secretary, SEC 4 (Oct. 9, 1990), File No. S7-11-90; Merrill Lynch Study Comment, *supra* note 305, at IX-13.

<sup>324</sup>See Cleary, Gottlieb Study Comment, *supra* note 262, at 50; Structured Finance Task Force Study Comment, *supra* note 306, at 20-21. The rating agencies have told the Division that a financing whose securities are rated investment grade is structured in such a way as to address Investment Company Act concerns. A related issue is whether requiring a rating from more than one agency would be appropriate. While we believe that the vast majority of financings are rated by at least two agencies, we do not wish to impose unnecessary costs.

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interests of investors if the financing defaults.<sup>325</sup> The specific obligations of the trustee invariably are set forth in the P&S agreement, indentures, or similar documents. Of course, financings that publicly offer debt obligations are subject to the Trust Indenture Act,<sup>326</sup> and, accordingly, the trustees of these financings would generally be subject to those duties and responsibilities required by that Act. Similarly, this condition would not prevent issuers from continuing the industry practice of contractually agreeing to comply with the requirements of the Trust Indenture Act, even if they are exempt from that Act. We believe, however, that the Commission should request comment on whether other duties should be specified.<sup>327</sup>

The proposed rule would require that the trustee be a bank that is qualified to serve as a trustee **of** a UIT. Accordingly, the trustee of a securitized asset pool would be required to be a bank whose aggregate capital, surplus, and undivided profits is not less than \$500,000.<sup>328</sup> The definition of qualified trustee would be consistent with industry practice.

The trustee also could not be affiliated with the issuer. Accordingly, a sponsor, servicer, or credit enhancer of a structured financing could not act as trustee.<sup>329</sup> This limitation is necessary because the sponsor, which also may act as servicer, often is a bank that would otherwise be a qualified trustee. Absent this prohibition, the sponsor could act in all capacities of the pool, without any independent party monitoring the issuer's obligations to investors. The trustee in a publicly offered structured financing usually is a commercial bank that is not affiliated with any parties to the transaction. In addition, the requirement that the trustee not be affiliated with the issuer is similar to a requirement in the Trust Indenture Act.<sup>330</sup>

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<sup>325</sup>See *supra* notes 114-121 and accompanying text.

<sup>326</sup>See *supra* notes 114-117 and accompanying text.

<sup>327</sup>We considered but rejected proposing that the requirement found in section 26(a)(2) also should apply, because that provision's limits on fees are not compatible with the fee structure typically used in structured financings.

<sup>328</sup>See Investment Company Act § 26(a)(1); 15 U.S.C. § 26(a)(1).

<sup>329</sup>This requirement would not preclude the trustee from owning securities issued by the structured financing.

<sup>330</sup>See *supra* note 117.

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We believe that these conditions effectively will codify the protections imposed by the marketplace, thus addressing Investment Company Act investor protection concerns. At the same time, we believe that the rule is sufficiently flexible to allow for continued innovation in the structured finance market.

We also believe that the rule would meet the standards of section 6(c). That is, it would be appropriate in the public interest and consistent with the protection of investors and the purposes intended by the policy and provisions of the Act. The rule would be in the public interest since it would facilitate the continued development of the structured finance market, a vitally important financing technique. More importantly, we believe that the track record of structured finance and the conditions of the proposed rule clearly would enable the Commission to find that the rule would be consistent with the protection of investors and the purposes fairly intended by the provisions of the Investment Company Act.

The legislative history of the Act indicates that, at a minimum, section 6(c) enables the Commission to address situations that Congress either could not have considered because they did not exist in 1940, or had not considered because they were overlooked.<sup>331</sup> Congress did not consider structured finance in 1940 or 1970. Moreover, to the extent that Congress later considered the development of the structured finance industry and the Commission's exemptive authority, it indicated that the Commission should use its exemptive authority flexibly to accommodate the industry's development, where consistent with investor protection.<sup>332</sup>

#### **D. Other Options Considered**

As an alternative, the Division considered, but rejected, recommending that structured financings be conditionally exempted from the Act through a statutory amendment, rather than by rule. We believe that rulemaking is preferable, since it gives the Commission the opportunity to craft the specific terms through the notice and comment process. It also is likely the quickest means to address the

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<sup>331</sup>See, e.g., *1940 Senate Hearings*,<sup>supra</sup> note 252, at 872 (Commissioner Healy stated that "it seemed possible and even quite probable that there might be companies — which none of us have been able to think of — that ought to be exempted.") See also *In re J.D. Gillespie*, 13 S.E.C. 470, 477 (1943) ("Section 6(c) was included in the Act to give us authority to deal with the situations that could not be foreseen at the time of its passage, to exempt persons, securities or transactions falling within the literal language of the Act but not fairly intended to be governed by its policy or provisions.").

<sup>332</sup>See *supra* note 273.

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problems caused by the Act today. Rulemaking also gives the Commission the flexibility to amend the requirements for exemption, if later market developments indicate that the rule is impeding the market or that additional safeguards are needed.

We also rejected another option for the reform of the treatment of structured finance under the Investment Company Act. A few commenters argued that the definition of "security" under the Investment Company Act, like the definition of security under the Securities Act and the Exchange Act, should be interpreted to exclude "commercial" instruments.<sup>333</sup> Under this approach, structured financings backed by these instruments, as well as other types of pooled vehicles that invest in these assets, would not be considered investment companies. This proposal is based on the fact that many investment companies primarily invest in liquid, readily marketable instruments, while structured financings generally are used to convert illiquid debt instruments into liquid capital market instruments. In our view, this approach neither reflects the true nature of the structured finance market nor addresses potential investor protection concerns.

Many of the illiquid debt instruments are assets that are generated in a commercial context, such as mortgages and consumer receivables. Such instruments generally are not securities for purposes of the Securities Act and the Exchange Act, under the Supreme Court's analysis in *Reves v. Ernst & Young*.<sup>334</sup> In *Reves*, the Court stated that every note is presumed to be a security, but that the presumption can be rebutted by a showing that the note bears a strong resemblance to any of the notes on a judicially crafted list of notes that are not deemed to be securities, or if it is determined, looking to four factors identified in *Reves*, that the note should be on the list.<sup>335</sup> Included on this list are notes

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<sup>333</sup>See, e.g., Memorandum from Sidley & Austin to the Division of Investment Management, on behalf of the National Commercial Finance Association, on the Application of the Investment Company Act of 1940 to the Asset-Backed Commercial Finance Services Industry, SEC 1-2, 20, 26-27 (Oct. 23, 1987) [hereinafter Sidley & Austin Memorandum], accompanying Letter from Sidley & Austin, on behalf of the National Commercial Finance Association, to Jonathan G. Katz, Secretary, SEC (Oct. 9, 1990), File No. S7-11-90 [hereinafter Sidley & Austin Study Comment].

<sup>334</sup>110 S.Ct. 945, 951 (1990) (but holding demand notes in question to be securities). Commercial loans such as bank loans *are* securities for purposes of the Public Utility Holding Company Act of 1935, 15 U.S.C. §§ 79a to 79z-6.

<sup>335</sup>110 S.Ct. at 952.

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delivered in consumer financings and notes secured by residential mortgages.<sup>336</sup>

This approach would be problematic in several respects. Although there are some differences in the types of assets typically held by registered investment companies and those held by structured financings, there is a significant degree of overlap. Many registered investment companies invest in instruments that generally have been held not to be securities under the Securities Act or the Exchange Act. For example, many money market funds invest heavily in instruments such as time deposits.<sup>337</sup> Also, a number of closed-end investment companies have as their primary investments bank loan participations, which generally have not been deemed to be securities under the Securities Act and the Exchange Act.<sup>338</sup> Such issuers should remain subject to the Commission's jurisdiction under the Investment Company Act.<sup>339</sup> Many structured financings

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<sup>336</sup>*Id.* at 951.

<sup>337</sup>See, e.g., *Marine Bank v. Weaver*, 455 U.S. 551 (1982) (holding that a bank certificate of deposit was not a security under the Securities Act and the Securities Exchange Act).

<sup>338</sup>See, e.g., *McVay v. Western Plains Corp.*, 823 F.2d 1395, 1399 n.4 (10th Cir. 1987); *Union Planters Nat'l Bank v. Commercial Credit Business Loans*, 651 F.2d 1174, 1185 (6th Cir.), cert. denied, 451 U.S. 91 (1981). At note 5 of its brief, as amicus curiae, in the case of *Banco Espanol De Credito v. Security Pacific National Bunk* (Nos. 91-7563, 91-7571 (2d Cir. 1992)), the Commission argued that certain short-term loan notes, bearing a "superficial resemblance to traditional loan participations" (*id.* at 2), were securities because, among other things, they were purchased for an investment purpose rather than as part of a commercial lending business or to facilitate an independent business relationship with the borrower. *Id.* at 4. The Commission distinguished the notes in question from traditional loan participations, and distinguished this case from those cases holding that traditional loan participations are not securities. *Id.* at 14-15. See Chapter 11 for a discussion of investment companies that invest in loan participations.

<sup>339</sup>In other words, while excluding commercial instruments from the disclosure requirements of the Securities Act and the Exchange Act is consistent with the purposes of those Acts, issuers that pool these instruments nevertheless may be functionally equivalent to, and present the same investor protection concerns as, investment companies that invest in securities that are registered under those Acts. See Brief for the United States as Amicus Curiae at 22-23, *Marine Bank v. Weaver*, 455 U.S. 551 (1982) ("While the language in the Investment Company Act's definition of the term 'security' is identical to that in the Securities Act, the regulatory context under the Investment Company Act differs fundamentally from that under the Securities Act and the Securities Exchange Act. The Investment Company Act broadly regulates the operation and management of investment companies. Because the relationship between a money market fund and its shareholders is identical to the relationship between any other investment company and its shareholders, and because the assets of both investment media are highly liquid and are subject to external management, investor protection requires that money market funds continue to be regulated under the Act.").

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have as their primary assets instruments that are quintessentially securities, such as high yield bonds, industrial development bonds, and agency pass-through certificates. In addition, most structured financings provide for short-term reinvestment of proceeds collected on their assets; that reinvestment typically is in liquid instruments such as Treasury bills and commercial paper.

Moreover, a *Reves* approach would treat structured financings inconsistently: structured financings backed by commercial assets would be unconditionally exempt, while financings using financial assets would be required to register and comply with the full complement of the Act's requirements. Thus, for example, financings backed by agency securities or high yield bonds could not be publicly offered in the United States, even if their structural protections were similar to, or better than, exempt financings. The practical effect of this approach would be to continue to distort the market for structured financings.

### **E Section 3(c)(5)**

Finally, we address whether section 3(c)(5) should be amended to remove structured financings from the exception. Absent an amendment, structured financings that come within the exception would not be required to meet the conditions of our proposed rule for exemption. Thus, structured financings would continue to be treated inconsistently, depending solely on the type of assets being securitized.<sup>340</sup>

Amending section 3(c)(5) is not a simple matter. Of course, any amendment to exclude structured financings would need to be crafted so that finance companies or real estate businesses do not become subject to the Act. Some types of structured financings, however, possess attributes similar to those of commercial finance and mortgage banking companies. Moreover, the

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<sup>340</sup>There are other issues with respect to section 3(c)(5) that could be addressed through a statutory amendment. For example, one commenter asserted that current interpretations of sections 3(c)(5)(A) and 3(c)(5)(B) are unduly narrow, so that finance companies that provide loans secured by a pledge of the borrower's inventory and receivables cannot rely on the exception. See Sidley & Austin Study Comment, *supra* note 333, at 2. See also Sidley & Austin Memorandum, *supra* note 333, at 15-17, 25-27, 31-43. Such issues are outside the scope of our review of the treatment of structured financings, and the Division has not developed specific recommendations with regard to these matters.

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commercial finance and mortgage banking industries have evolved considerably since 1940 and it is difficult to make generalizations about them.<sup>341</sup>

While structured financings appear at first blush to have some operational distinctions from finance companies, upon closer examination the dividing lines are far from clear. Thus, it is difficult to amend section 3(c)(5) in a way that would prevent structured financings from relying on the 3(c)(5) exception without also inadvertently preventing some finance companies from relying on the exception.

The Division considered the suggestion made by the ICI that section 3(c)(5) be amended to exclude issuers from the exception, and thus, bring within the Act, those that do not have an "active business."<sup>342</sup> Because there are structured finance issuers whose life extends beyond a single deposit of assets and issuance of securities, and whose acquisition of additional assets is made pursuant to carefully prescribed conditions,<sup>343</sup> we are not certain that this distinction is feasible.

The Division also considered whether section 3(c)(5) should be amended to exempt only those finance companies that are primarily engaged in the business of making, purchasing, or otherwise acquiring commercial assets (*e.g.*, notes, drafts, open accounts receivable) from unaffiliated parties. Some major finance companies acquire assets from affiliates, however, or originate or acquire their assets to facilitate an affiliate's operating business. For example, a number of large finance companies originate loans to support sales by affiliates (*e.g.*, the finance companies owned by automobile manufacturers). Moreover, some

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<sup>341</sup>Non-mortgage structured financings have relied primarily on subparagraphs (A) and (B) of section 3(c)(5) to avoid regulation under the Act. See *supra* notes 259-262 and accompanying text. Apparently, the traditional distinctions between companies engaged in factoring, sales financings, and other types of commercial financing activities have been substantially reduced since 1940. Today, a finance company may be engaged in several kinds of financing activities or variations thereof. See Sidley & Austin Memorandum, *supra* note 333, at 5-6. Some finance companies originate loans, while others purchase loans or receivables, often from unaffiliated companies, which they typically hold to maturity.

<sup>342</sup>ICI Memorandum, *supra* note 298, at page 2 of attachment thereto (suggesting adding the following sentence at the end of section 3(c)(5): "This exemption shall be applicable only to persons engaged in an active business, and not to limited purpose entities engaged in no other business other than investing in or owning securities and receivables which are organized after [date of enactment]").

<sup>343</sup>For examples, see *supra* discussions of master trusts (Section III.A.3.d.) and asset-backed commercial paper programs (Section III.A.3.e.).

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structured financings, such as asset-backed commercial paper programs, obtain their assets through unaffiliated transactions, and accordingly could continue to rely on the exclusion.

Finally, the Division considered recommending that the section be amended to provide that excluded companies must have internal management, in the form of their own officers and directors. At least preliminarily, we do not believe that this approach would provide meaningful distinctions. For example, while master trusts and asset-backed commercial paper programs do not have independent officers making credit determinations, they do have processes by which their assets are screened, pursuant to the terms of their organizational documents. If the exclusion were amended to require internal management, the sponsors of these issuers simply could add internal management to their structures, which would raise expenses, but would not increase investor protection. Also, many finance companies are wholly-owned subsidiaries of operating companies and the finance companies' managements are selected by the parent companies and cannot truly be said to be independent of the affiliates.<sup>344</sup>

We also considered whether the range of assets section 3(c)(5)(C) issuers may hold should be narrowed. Although the section was intended to except mortgage bankers that originated, serviced, and sold mortgages, other types of issuers have relied on it. Based on the broad language of clause (C), the Division has taken the position that issuers primarily engaged in investing in loans secured by real estate may rely on the exception as long as the principal amounts of the loans are fully secured by real estate at origination and the market value of the loans are fully secured by real estate at the time the issuers receive the loans.<sup>345</sup> The Division also has issued favorable no-action positions with respect to certain instruments that represent an interest (in the nature of a security) in an entity engaged in real estate activities. Most significantly, the Division has said that "whole pool" agency certificates may be considered interests in real estate.<sup>346</sup>

The Division has considered whether it should reconsider these positions. In particular, we believe that the whole pool interpretation may be unrealistic, since agency certificates clearly are in fact liquid securities and not interests in real estate. Moreover, whole pool holders in fact have a different economic

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<sup>344</sup>Until recently, another distinction between structured financings and finance companies was that structured financings were not continuous operations. This distinction ended with the development of asset-backed commercial paper programs and master trusts.

<sup>345</sup>See NAB Asset Corp., *supra* note 263. See also Citytrust (pub. avail. Dec. 19, 1990).

<sup>346</sup>See *supra* note 267 and accompanying text.

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experience than mortgage holders, largely because of the agency guarantees and the resulting increased liquidity of their interests.

. Because of the complexity of these issues, the Division believes that the Commission may wish to request public comment on the possible amendment of section 3(c)(5), including reversal of the whole pool interpretation, in the release accompanying the proposed exemptive rule for structured financings.

## **VI. Conclusion**

The Division recommends that the Commission propose a rule exempting structured financings from the definition of investment company, subject to conditions that recognize and build upon the operational and structural distinctions between structured financings and investment companies. The Commission also may wish to request public comment on the scope of section 3(c)(5)

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## Chapter 2

# Private Investment Company Exceptions

### I. Introduction and Summary

The Investment Company Act,<sup>2</sup> under section 3(c)(1),<sup>3</sup> excepts from the definition of investment company "[a]ny 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." The exception, often referred to as the "private investment company" exception, is used by a wide variety of issuers that provide important sources of capital to small businesses and others. At one end of the financial spectrum, small groups of investors known as investment clubs rely on it because registering and complying with the Act would be too costly. At the other end, well-capitalized investment pools with sophisticated investors rely on the exception to avoid substantive regulation under the Act. These pools include venture capital funds, acquisition vehicles, subsidiaries of large corporations formed to manage excess cash, leveraged buyout funds, hedge funds, and certain structured financings.

To rely on section 3(c)(1), an issuer must meet both elements of the exception. It may not have more than 100 holders of its debt and equity securities, other than purchasers of its commercial paper, *and* it may not be making or presently proposing to make a public offering. While the public offering prohibition is relatively straightforward: the 100 investor limit is complicated by a two-part attribution provision intended to prevent circumvention of the limit through layers of intermediaries. Section 3(c)(1)'s

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<sup>2</sup>On March 11, 1992, the Commission approved the Division's recommendations discussed in this chapter to amend section 3(c)(1) of the Investment Company Act and to create a new exception from the Act for issuers whose securities are held exclusively by qualified purchasers. These proposals were introduced in Congress as part of the Small Business Incentive Act of 1992. S. 2518, 102d Cong., 2d Sess. (Apr. 2, 1992); H.R. 4938, 102d Cong., 2d Sess. (Apr. 9, 1992). See *Hearings on the Small Business Incentive Act of 1992*, 102d Cong., 2d Sess. (Mar. 26, 1992).

\*Investment Company Act of 1940, 15 U.S.C. § 80a.

<sup>3</sup>15 U.S.C. § 80a-3(c)(1).

<sup>4</sup>An offering that qualifies as a non-public offering under section 4(2) of the Securities Act of 1933 (15 U.S.C. § 77d(2)) and rule 506 of Regulation D (17 C.F.R. § 230.506) also generally qualifies as non-public for purposes of section 3(c)(1). Santa Barbara Securities (pub. avail. April 8, 1983).

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attribution provision also determines **which** section 3(c)(1) issuers are deemed to be investment companies for purposes of the "fund of funds" investment restrictions of section 12(d)(1) of the Act?

Companies relying on section 3(c)(1) also must take care to avoid "integration" with related issuers.<sup>6</sup> If other issuers are integrated with the private investment company, their security holders will be aggregated with the security holders of the private investment company for purposes of determining compliance with the 100 investor limit?

The private investment company exception has fostered the development of investment vehicles well-suited for sophisticated investors<sup>8</sup>. Often, however, large-scale capital participation by sophisticated investors in private investment companies is frustrated by the requirements of section 3(c)(1). For issuers whose securities are owned exclusively by sophisticated investors, the public offering prohibition and 100 investor limit are unnecessary constraints not supported by sufficient public policy concerns. Therefore, the Division recommends an amendment to the Investment Company Act to create a new exception for funds whose securities are held exclusively by "qualified purchasers" as defined by rule. The new exception would be premised on the theory that "qualified purchasers" do not need the Act's protections because they are able to monitor such matters

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<sup>5</sup>15 U.S.C. § 80a-12(d)(1). The attribution provision of section 3(c)(1) and its role in determining which issuers are subject to the restrictions of section 12(d)(1) are described *infra* notes 13-16 and accompanying text.

<sup>6</sup>The integration concept allows the Commission to look behind ostensibly separate issues, issuers, or transactions to determine if, in economic reality, they are actually a single issue, issuer, or transaction. See generally Interpretive Release Relating to the Securities Act and General Rules and Regulations Thereunder, Securities Act Release No. 4552, 1 Fed. Sec. L. Rep. (CCH) ¶ 2770 at 2918 (Nov. 6, 1962) (articulating five factors relevant to the question of integration under the Securities Act).

<sup>7</sup>See, e.g., Meadow Lane Associates, L.P. (pub. avail. May 24, 1989); Frontier Capital Management Company, Inc. (pub. avail. July 13, 1988); PBT Covered Option Fund (pub. avail. Feb. 17, 1979). For a discussion of the integration issue and other questions that arise under section 3(c)(1), see Thomas P. Lemke & Gerald T. Lins, *Private Investment Companies Under Section 3(c)(1) of the Investment Company Act of 1940*, 44 BUS. LAW. 401, 424-28 (1989).

<sup>8</sup>This appears to be a relatively recent development. In 1940, institutional participation in pooled investment vehicles was relatively minor. Since that time, institutional investors have become active participants. At the end of 1990, they accounted for approximately 34% of total mutual fund assets. INVESTMENT COMPANY INSTITUTE, 1991 MUTUAL FUND FACT BOOK: INDUSTRY TRENDS AND STATISTICS FOR 1990, at 53 (1991).

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as management fees, transactions with affiliates, corporate governance, and leverage.

The Division also recommends legislation to amend section 3(c)(1). The current structure of section 3(c)(1) is overly complicated and unnecessarily restricts investments by both corporate investors and registered investment companies. Reform of section 3(c)(1) would encourage participation in private investment companies without lessening investor protection?

Finally, the Division believes that the inter-fund, or "fund of funds," investment restrictions of section 12(d)(1) ~~as~~ applied to private issuers should be revised. Specifically, section 3(c)(1) should be amended to eliminate section 12(d)(1)'s limits on investments by registered investment companies in private investment companies. In order to protect the public shareholders of registered investment companies, however, the restrictions of section 12(d)(1) should apply to all investments by private issuers in registered investment companies. This approach also should be incorporated in the proposed "qualified purchaser" exception.

Section 11 of this chapter discusses the private investment company exception in section 3(c)(1) and our recommendations to modify the attribution provision and the "fund of funds" restrictions in that exception. Section 111 discusses our recommendation to create a new exception under the Investment Company Act for funds whose securities are held exclusively by "qualified purchasers." Section IV briefly describes other options that we considered.

## 11. The Private Investment Company Exception

Section 3(c)(1) reflects Congress's belief that federal regulation of private investment companies is not warranted. The 100 investor limit and public ~~offering~~ prohibition are both designed to ensure the private nature of exempted issuers.<sup>10</sup> When there is no public offering, the 100 investor limit, while

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<sup>9</sup>In connection with this change, the Division recommends a related amendment to section 3(a)(3) to prevent companies from avoiding regulation under the Act through investment in subsidiaries that qualify as section 3(c)(1) issuers. See *infra* note 18 and accompanying text. The Division recommends that the amendment to section 3(a)(3) also cover issuers relying on the new "qualified purchaser" exception.

<sup>10</sup>See SMALL BUSINESS INVESTMENT INCENTIVE ACT OF 1980, H.R. REP. NO. 1341, 96th Cong., 2d Sess. 34-35 (1980) [hereinafter 1980 HOUSE REPORT]. See also SEC, REPORT ON THE PUBLIC POLICY IMPLICATIONS OF INVESTMENT COMPANY GROWTH, H.R. REP. NO. 2337, 89th Cong., 2d Sess. 34-35 (1966) [hereinafter PPI REPORT] ("[t]he Act is also limited to companies in which there is a significant public interest, since it excludes from its coverage a company that has no more than 100 security holders and is neither making nor presently proposing to make a public offering of its securities") (footnotes omitted).

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somewhat arbitrary, reasonably reflects the point at which an issuer should not be regarded as a public investment company."<sup>11</sup> As David Schenker, the Chief Counsel to the Commission's Investment Trust Study, explained

You have the situation where there are personal holding companies. A family may have a substantial estate and has invested its money in marketable securities. In essence that is a private investment company, is it not? We do not want any part of it; and so we have said that even though you engage in the same type of activity as an investment company, which is within the purview of this section, if you have less than 100 security holders you are not a public investment company and not within the purview of this legislation.<sup>12</sup>

The legislative history of section 3(c)(1) indicates that the 100 investor limit represents an outer limit of an investor base likely to be composed of people with personal, familial, or similar ties. In some circumstances, investor protection concerns may be raised by small investment pools whose securities are held by investors of modest means, even if the pools have fewer than 100 investors. But the concept that the investors in these smaller pools are bound by personal or familial ties retains some validity, and, in any case, federal oversight of these pools under the Investment Company Act would be impractical.

To prevent circumvention of the 100 investor limit, section 3(c)(1) currently includes a two-part attribution provision that, in some instances, requires an entity seeking to rely on the exception to "look through" its security holders to their underlying investors. The attribution provision is most easily explained by a sample fact situation. Assume Company B is seeking to rely on section 3(c)(1). If one of Company B's security holders, Company A, beneficially owns ten percent or more of the voting securities of Company B, then the security holders

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<sup>11</sup>"In a 1941 opinion, the Commission observed that the 100 investor limit "obviously is an arbitrary figure." *In re Maritime Corp.*, 9 S.E.C. 906, 909 n.2 (1941).

<sup>12</sup>*Investment Trusts and Investment Companies: Hearings on S. 3580 Before a Subcomm. of the Senate Comm. on Banking and Currency*, 76th Cong., 3d Sess. 179 (1940).

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of Company A are counted as security holders of Company B (*part I of the attribution provision*), unless Company A has no more than ten percent of its assets in securities of section 3(c)(1) issuers (*part II*).<sup>13</sup>

This two-part attribution provision is also pivotal in determining which section 3(c)(1) issuers are deemed to be investment companies for purposes of section 12(d)(1). Section 12(d)(1) is intended to restrict the pyramiding of funds by limiting the purchase of registered investment company securities by any investment company (whether or not registered), and the purchase of securities of any investment company (whether or not registered) by registered investment companies.<sup>14</sup> Unlimited pyramiding raises public policy concerns because a fund acquiring another fund's securities could exercise undue influence over that fund or disrupt its orderly management through the threat of redemption. Pyramiding also may result in a layering of costs to investors through duplicate administrative expenses, sales charges, and advisory fees without providing any significant benefit.<sup>15</sup>

Under current section 3(c)(1), only those issuers that would be investment companies but for the second part of that section's attribution provision (*i.e.*, they have large security holders, but those holders do not have more than ten percent of their assets in securities of section 3(c)(1) issuers) are deemed to be investment companies for the limited purposes of the anti-pyramiding restrictions in section 12(d)(1).<sup>16</sup> All other section 3(c)(1) issuers are not investment companies for the purposes of the anti-pyramiding restrictions of section 12(d)(1).

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<sup>13</sup>Prior to 1980, the attribution provision was more restrictive in that the 10% restriction was applied across the board. That is, beneficial ownership of 10% or more of Company B's outstanding voting securities was deemed to be beneficial ownership by all of the security holders of Company A, without exception.

<sup>14</sup>Section 12(d)(1) prohibits such purchases if, after the purchase, the acquiring company and any company or companies controlled by it own (i) more than three percent of the total outstanding voting stock of the acquired company; (ii) securities issued by the acquired company having an aggregate value of more than five percent of the total assets of the acquiring company; or (iii) securities issued by the acquired company and all other investment companies having an aggregate value of more than ten percent of the total assets of the acquiring company.

<sup>15</sup>PPI REPORT, *supra* note 10, at 311-24. The PPI Report noted the benefit of the fund holding company structure as a vehicle to achieve diversification was largely "illusory." Id. See *infra* note 22.

<sup>16</sup>The anti-pyramiding restriction in section 3(c)(1) was added in 1980, when the attribution provision was narrowed. SMALL BUSINESS SECURITIES ACTS AMENDMENTS OF 1980, S. REP. NO. 958, 96th Cong., 2d Sess. 20 (1980); 1980 HOUSE REPORT, *supra* note 10.

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The two-part attribution provision in section 3(c)(1) is both overly broad and extremely confusing. In many instances, the current test exaggerates public interest by counting the security holders of corporate investors when these security holders do not have a significant economic interest in a section 3(c)(1) issuer's performance. Moreover, investments in section 3(c)(1) issuers by companies which are not themselves investment companies (whether or not registered) generally do not, standing alone, implicate the concerns respecting the layering of intermediaries that the attribution test is intended to address. Put another way, if an intermediate investing entity is not itself a registered investment company or a private investment company, attribution is unnecessary.

Thus, we recommend an amendment to narrow the attribution provision. Under our proposal, if Company A, the intermediate investing entity, is itself not an investment company as defined in section 3 of the Investment Company Act, or is not relying on the section 3(c)(1) private investment company exception or the new "qualified purchaser" exception we propose below, Company A's security holders would not be counted for purposes of the 100 investor limit.<sup>17</sup>

In connection with this change, we recommend a related amendment to section 3(a)(3) of the Act to provide that the securities of a majority-owned subsidiary relying on section 3(c)(1) would not be excluded from the definition of "investment securities" under section 3(a)(3). This amendment would preclude a company that would itself fall within the definition of an investment company under section 3(a)(3) from avoiding regulation under the Act through investment in a section 3(c)(1) subsidiary.<sup>18</sup>

In addition, the Division believes that investments by registered investment companies in section 3(c)(1) issuers should not be constrained by section 12(d)(1). Any anti-pyramiding concerns raised in this context are minimized by the other provisions of the Act regulating the conduct of registered funds. Investments by

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<sup>17</sup>More specifically, the Division recommends legislation to narrow the attribution provision to provide that if an issuer seeking to rely on section 3(c)(1) has a 10% holder of the issuer's voting securities that: (i) is a registered investment company pursuant to section 3, or (ii) is itself an excepted section 3(c)(1) private investment company, or (iii) is a proposed section 3(c)(7) investment company whose securities exclusively are held by sophisticated investors, the issuer must count the security holders of the 10% holder of the issuer's voting securities as its own.

<sup>18</sup>Section 3(a)(3) generally provides that an investment company includes any company with more than 40% of its assets in investment securities. The definition of investment securities under section 3(a)(3) excludes, among other things, securities issued by majority-owned subsidiaries that are not investment companies; because of the section 3(c)(1) exclusion, the securities of a majority-owned section 3(c)(1) issuer are not investment securities. In light of the proposed change in the attribution provision and in the absence of the recommended amendment to section 3(a)(3), companies could avoid regulation under the Act by "downstreaming" their investment activities through a section 3(c)(1) subsidiary.

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registered investment companies in section 3(c)(1) issuers, for example, are governed by the conflict-of-interest provisions of section 17 of the Act<sup>19</sup> as well as those concerning breaches of fiduciary duty by the registered company's investment adviser under section 36.<sup>20</sup> The latter could come into play where investments in section 3(c)(1) issuers result in unnecessary duplication of fees or expenses. Moreover, as a result of the recommended change in section 3(c)(1)'s attribution provision, a registered fund's investment would be limited to ten percent of any one section 3(c)(1) issuer.<sup>21</sup> Removing section 12(d)(1)'s restrictions in connection with investments by registered investment companies in section 3(c)(1) issuers would eliminate unnecessary constraints without compromising important investor protections.<sup>22</sup>

The Division believes, on the other hand, that limitations on the ability of *all* section 3(c)(1) issuers to invest in registered investment companies are necessary to protect the public shareholders of registered investment companies. Private issuers, excepted from regulation under the Act, could acquire controlling interests and exert undue influence over registered funds, disrupting their portfolio management through the threat of redemption.<sup>23</sup>

Accordingly, the Division recommends amendment of section 3(c)(1) to eliminate application of section 12(d)(1) in connection with investments by registered investment companies, but to require that all section 3(c)(1) issuers be subject to section 12(d)(1)'s restrictions governing the purchase of registered investment company securities.<sup>24</sup>

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<sup>19</sup>15 U.S.C. § 80a-17.

<sup>20</sup>15 U.S.C. § 80a-35

"The amended attribution provision would count toward the 100 investor limit, without exception, the shareholders of ~~an~~ investment company owning 10% or more of a section 3(c)(1) issuer; as a result, the issuer would not be eligible for the private investment company exception.

<sup>22</sup>The diversification benefits derived from inter-fund investments depend largely on the investment objective and policies of the issuer in which the investment is made. Because private investment companies often offer specialized investment services, investment in these vehicles may enable the shareholders of registered funds to benefit from such services.

<sup>23</sup>While similar concerns are manifested whenever large institutional security holders threaten to redeem, the threat is compounded when the redeeming security holder is an investment company that must in ~~turn~~ meet its own redemption requests. PPI REPORT, *supra* note 10.

<sup>24</sup>To cover the other side of transactions involving open-end funds, section 12(d)(1) also would apply to a registered open-end investment company's sale of its securities to a section 3(c)(1) issuer. The application of section 12(d)(1) to all section 3(c)(1) issuers under the proposal would not affect existing holdings in registered investment companies, since section 12(d)(1) prohibits  
(continued...)

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The proposed amendments to section 3(c)(1) would facilitate participation in private issuers. As a result of the revised attribution provision, section 3(c)(1) would not limit investments by corporate, non-investment company investors. In the case of registered investment companies, the combined effect of the proposed changes to the attribution provision and the application of section 12(d)(1) would be to raise the limit on registered investment company purchases of private issuers from three percent to ten percent of any one such issuer.<sup>25</sup>

### **111. A Qualified Purchaser Exception**

In contrast to the existing private investment company exception, an exception for funds owned by sophisticated investors would be premised on the theory that such investors can adequately safeguard their interests in a pooled investment vehicle without extensive federal regulation.<sup>26</sup> As an alternative to the more narrow section 3(c)(1), such an exception could be relied upon by venture capital funds and other vehicles to increase funding available for small businesses as well as larger concerns.

Accordingly, the Division recommends amendment of the Investment Company Act to add a new section -- section 3(c)(7) -- to except from the Act any

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<sup>24</sup>(...continued)

only purchases or other acquisitions that cause holdings to exceed the numerical limits in the section.

<sup>25</sup>As indicated *supra* notes 14-16 and accompanying text, section 12(d)(1) currently limits investments by a registered fund to no more than three percent of any one private issuer that has a security holder owning ten percent or more of the issuer's voting securities.

<sup>26</sup>The Commission's release soliciting comments on the reform of investment companies specifically requested comment on whether the private investment company exception should be expanded to include entities that sell their securities to an unlimited number of institutional security holders. Request for Comments on Reform of the Regulation of Investment Companies, Investment Company Act Release No. 17534 (June 15, 1990), 55 FR 25322 [hereinafter Study Release]. Commenters addressing this issue generally supported an expansion, although they differed on how best to implement the change. The commenters included Aetna Life Insurance Company; the American Council of Life Insurance; Bankers Trust Company; The Chase Manhattan Bank, N.A.; Chemical Bank; Citicorp; Cleary, Gottlieb, Steen & Hamilton; Davis Polk & Wardwell; Dechert Price & Rhoads; The Equitable Life Assurance Society of the United States; Fidelity Management & Research Company; IDS Financial Services, Inc.; the Investment Company Institute; Levitt Greenberg Kaufman & Goldstein, P.C.; certain members of The Federal Regulation of Securities Committee of the Los Angeles County Bar Association; Merrill Lynch & Co., Inc.; The New York Clearing House Association; PaineWebber Development Corporation; Paloma Partners Management Company Inc.; Ropes & Gray; S.G. Warburg & Co., Inc.; Shearson Lehman Brothers Inc.; Skadden, Arps, Slate, Meagher & Flom; State Street Bank and Trust Company; Stradley, Ronon, Stevens & Young (on behalf of DFA Investment Dimensions Group Inc. and Dimensional Fund Advisors Inc.); The Vanguard Group, Inc.; and Weil, Gotshal & Manges.

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issuer whose securities are beneficially owned exclusively by one or more persons who, at the time of acquisition, are "qualified purchasers."<sup>27</sup> There would be no limit on the number of investors or a prohibition on public offerings, provided the issuer's securities were sold to "qualified purchasers." To protect the public shareholders of registered investment companies, we recommend that the restrictions of section 12(d)(1) apply to investments by proposed section 3(c)(7) issuers in registered investment companies for the same reasons as issuers relying on section 3(c)(1).<sup>28</sup> As in the case of the section 3(c)(1) exception, we also recommend amendment of section 3(a)(3) of the **Act** to prevent companies from avoiding Investment Company Act regulation through investments in subsidiaries that qualify as section 3(c)(7) issuers.<sup>29</sup>

To implement the new exception, we also propose the adoption of a new section 2(a)(51) to define qualified purchaser to be any person so defined by rule, based on such factors as financial sophistication, net worth, knowledge and experience in financial matters, amount of assets owned or under management, relationship with the issuer, or such other factors as the Commission determines to be within the intent of the section.<sup>27</sup> This approach would enable the Commission to respond to changing financial conditions and to benefit from the public comment process.

While the class of investors for a sophisticated investor exception would have to be defined adequately to ensure that investors are capable of safeguarding their interests, the idea that some investors do not need the protections of the federal securities laws is certainly not novel. A number of exemptive or safe harbor provisions under the federal securities laws are based, in part, on the degree of sophistication of investors. The three most noteworthy are section 4(6)

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<sup>27</sup>Evaluating a security holder's status at the time of acquisition would ensure that subsequent changes in the holder's net worth or other attributes would not result in the issuer inadvertently becoming an investment company.

<sup>28</sup>See *supra* notes 14-15 & 23 and accompanying text.

<sup>29</sup>See *supra* note 18 and accompanying text.

<sup>30</sup>An attribution provision designed to preclude circumvention of the qualified purchaser standard is unnecessary, since any concerns about evasion of the requirements of the exception could be addressed adequately in rulemaking. In defining eligible investors, the Commission also could decide to provide reasonable care defenses similar to those in Regulation D and rule 144A.

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of the Securities Act,<sup>31</sup> rule 144A under that Act,<sup>32</sup> and rule 205-3<sup>33</sup> under the Advisers Act.<sup>34</sup>

For example, section 4(6) of the Securities Act exempts from the registration requirements of that Act transactions involving offers or sales by an issuer solely to one or more "accredited investors," if the aggregate offering price of the issue does not exceed \$5 million, there is no advertising or public solicitation in connection with the transaction, and the issuer files a prescribed notice with the Commission. For purposes of section 4(6), an "accredited investor," as defined in section 2(15) of the Securities Act,<sup>35</sup> includes all banks (whether acting in an individual or fiduciary capacity), insurance companies, registered investment companies, business development companies, and small business investment companies. The term also includes any employee benefit plan, including an individual retirement account, subject to the provisions of the Employee Retirement Income Security Act of 1974 ("ERISA")<sup>36</sup> if the investment decision is made by a plan fiduciary that is either a bank, insurance company, or registered investment adviser.

The Commission also may designate other persons as accredited investors on the basis of such factors as financial sophistication, net worth, knowledge and experience in financial matters, or amount of assets under management.<sup>37</sup> In Regulation D, an "accredited investor" also is defined to include, among other things, any state or local government employee benefit plan with total assets in excess of \$5 million, any ERISA plan if the investment decision is made by a plan fiduciary that is either a bank, a savings and loan association, insurance company, or registered investment adviser, or if the plan has total assets in excess of \$5 million, corporations, business trusts, partnerships, or charitable organizations with total assets in excess of \$5 million, executive officers and directors of the issuer, private business development companies, natural persons with a net worth (or joint net worth with a spouse) of \$1 million, and natural persons with individual income of \$200,000 in each of the last two years or joint income with

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<sup>31</sup>15 U.S.C. § 77d(6).

<sup>32</sup>17 C.F.R. § 230.144A.

<sup>33</sup>17 C.F.R. § 275.205-3.

<sup>34</sup>Investment Advisers Act of 1940, 15 U.S.C. § 80b.

<sup>35</sup>15 U.S.C. § 77b(15).

<sup>36</sup>Employee Retirement Income Security Act of 1974, 29 U.S.C. § 1001.

<sup>37</sup>Securities Act § 2(15)(ii), 15 U.S.C. § 77b(15)(ii).

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a spouse in excess of \$300,000 and a reasonable expectation of reaching that income level in the current year.<sup>38</sup>

Rule 144A under the Securities Act provides a non-exclusive safe harbor for resales of restricted securities to "qualified institutional buyers." Qualified institutional buyers include (1) certain types of institutional purchasers that own and invest on a discretionary basis at least \$100 million in securities, including any insurance company, investment company, business development company, small business investment company, state plan, employee benefit plan, charitable organization, corporation, partnership, business trust, or investment adviser; (2) any registered dealer that owns and invests on a discretionary basis at least \$10 million in securities; any registered investment company that is part of a family of investment companies with at least \$100 million in securities; and (3) any bank or savings and loan that owns and invests at least \$100 million and has an audited net worth of at least \$25 million. In addition, Rule 205-3 exempts from the restrictions on performance-based advisory fees in section 205 of the Advisers Act<sup>39</sup> certain contracts with sophisticated clients, including advisory clients with at least \$500,000 under management with the adviser and clients with a net worth of at least \$1,000,000.

Given the many risks to investors of committing assets to managed pools, the Division believes the ability to evaluate unregulated investment companies requires a high degree of sophistication. Consequently, we believe that an accredited investor standard would be too low,<sup>40</sup> and that, at least initially, the definition of qualified institutional buyer in rule 144A would represent an appropriate level of sophistication for institutions. We also believe that a standard could be developed to permit certain natural persons to invest in proposed section 3(c)(7) issuers; where such persons possess a high degree of

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<sup>38</sup>17 C.F.R. § 230.501(a).

<sup>39</sup>15 U.S.C. § 80b-5.

<sup>40</sup>In response to the Study Release (supra note 26), most proponents of a new exception favored an accredited investor standard. See, e.g., Letter of the American Council of Life Insurance to Jonathan G. Katz, Secretary, SEC 75-78 (Oct. 10, 1990), File No. S7-11-90; Letter from Merrill Lynch & Co., Inc. to Jonathan G. Katz, Secretary, SEC VII-1 to 8 (Oct. 18, 1990), File No. S7-11-90 ("Merrill Lynch Study Comment"); Letter of Weil, Gotshal & Manges to Jonathan G. Katz, Secretary, SEC (Oct. 9, 1990), File No. S7-11-90. Others commenters favored a qualified institutional buyer standard. See Letter of Cleary, Gottlieb, Steen & Hamilton to Jonathan G. Katz, Secretary, SEC 14-17 (Oct. 12, 1990), File No. 57-11-90; Memorandum of the Investment Company Institute, Amendment of Section 3(c)(1) of the Investment Company Act of 1940 9-11 (undated), File No. S7-11-90; Letter of Ropes & Gray to Jonathan G. Katz, Secretary, SEC 4 (Oct. 9, 1990), File No. S7-11-90.

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financial sophistication, they would be fully capable of evaluating and assuming the risks associated with the new section 3(c)(7) pools.

Of course, many investors who would be able to invest in the new section 3(c)(7) issuers nevertheless may choose to invest instead in registered investment companies, relying on the protections afforded by the existing regulatory structure. Some institutional investors are limited by law as to the types of investments that they may make, and may be required to invest only in registered investment companies. Moreover, fiduciaries may be reluctant to take the risks associated with investments in unregistered investment companies and may choose instead to invest only in registered companies. Our recommendation, if implemented, would not limit the access of large investors to registered investment companies.

#### **IV. Other Options Considered**

In response to the Commission's solicitation of comments on reform of the regulation of investment companies,<sup>41</sup> commenters favoring a sophisticated investor exception generally asserted that funds sold exclusively or primarily to sophisticated investors should be excepted from all provisions of the Act. A few, however, argued that such companies should be registered and remain subject to some of the Act's requirements if they have more than 100 security holders.<sup>42</sup> The Division believes no sufficiently useful governmental purpose is served by

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<sup>41</sup>Study Release, supra note 26.

<sup>42</sup>One commenter recommended the elimination or modification of a number of the regulatory requirements of the Act for funds offered only to sophisticated investors, including the corporate governance provisions of section 16 (15 U.S.C. § 80a-16), the capital structure limitations of section 18 (15 U.S.C. § 80a-18), the restrictions on the timing of redemptions in section 22(e) (15 U.S.C. § 80a-22(e)), and the restrictions on affiliated transactions in section 17. Letter from Paul A. Hilstad, Vice President and Deputy General Counsel, IDS Financial Services, Inc., to Jonathan G. Katz, Secretary, SEC 25 (Oct. 2, 1990), File No. 57-11-90. Another commenter stated that "registration of institutional funds under the 1940 Act must continue," so that such funds will get pass-through tax treatment under Subchapter M of the Internal Revenue Code, but recommended the funds be exempt from certain portions of section 5 (15 U.S.C. § 80a-5) (definition of diversified company), section 12 (margin purchases and fund holding companies), section 13 (15 U.S.C. § 80a-13) (certain shareholder approval requirements), section 18 (redemptions in kind), section 22 (daily calculation of net asset value), and section 30 (15 U.S.C. 80a-29) (listing of portfolio holdings). Letter from Stephen W. Kline, Stradley, Ronon, Stevens & Young, on behalf of DFA Investment Dimensions Group, Inc. and Dimensional Fund Advisors, Inc., to Jonathan G. Katz, Secretary, SEC (Oct. 12, 1990), File No. S7-11-90. We believe that private investment companies would use an expanded exception, even if Subchapter M is not available to them. A number of issuers now avail themselves of section 3(c)(1), apparently finding a way to obtain acceptable tax treatment, either by organizing as limited partnerships or some other means.

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continuing to regulate funds owned exclusively by sophisticated investors.<sup>43</sup> Moreover, even limited Commission jurisdiction could lead to unrealistic assumptions on the part of investors concerning the ability of the Commission to police private investment companies.<sup>44</sup>

Proponents of a sophisticated investor exception also suggested two other approaches to accommodating increased participation by sophisticated investors. After consideration, we believe that these proposals are less desirable than the approach we recommend.

One approach would be to amend section 3(c)(1) to resemble section 4(2) of the Securities Act, which exempts from the registration requirements of that Act transactions by an issuer not involving a public offering.<sup>45</sup> Under this approach, the 100 investor limit in section 3(c)(1) would be deleted, thus making the exception available to any fund not making or presently proposing to make a public offering.<sup>46</sup>

The second approach would be to exclude sophisticated investors from counting towards the 100 investor limit in section 3(c)(1). Under this approach, a fund could have an unlimited number of sophisticated investors and rely on section 3(c)(1) so long as it had no more than 100 other participants.

We believe the 100 investor limit in the current private investment company exception reasonably reflects the point at which federal regulatory concerns are raised if any unsophisticated investors are involved. The 100 investor limit is an effective proxy for requiring that the investors have some relationship outside the pool, such as familial or social ties. To simply focus on

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<sup>43</sup>The Commission would continue to have the ability to monitor the securities trades of large private investment companies under sections 13(f) and 13(h) of the Securities Exchange Act of 1934 (15 U.S.C. §§ 78m(f) and 78m(h)).

<sup>44</sup>Of course, even if funds owned by more than 100 sophisticated investors were excepted from all of the Act, the Commission would retain the jurisdiction and responsibility under the Securities Act, the Exchange Act, and the Advisers Act to police securities fraud perpetrated by private investment companies and their sponsors.

<sup>45</sup>See, e.g., Letter from Davis Polk & Wardwell to Jonathan G. Katz, Secretary, SEC **36-40** (Oct. 10, 1990), File No. S7-11-90. One commenter suggested that an exception for issuers that sell exclusively to sophisticated investors should not turn on whether the issuer conducted a public offering, but only on whether the offering was a "directed public offering" to unsophisticated investors. Merrill Lynch Study Comment, *supra* note 40, at Ex. VII-6. The definition of "directed public offering" was derived from Regulation S (17 C.F.R. § 230.901) under the Securities Act, which defines "directed selling efforts" and "overseas directed offering." 17 C.F.R. § 230.902.

<sup>46</sup>Of course, there would also have to be a prohibition on ever having made a public offering. Otherwise, an issuer could deregister whenever it completed its initial public offering.

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whether or not an issuer had ever conducted a public offering would ignore that repeated private offerings or secondary market transactions could result in a supposedly private issuer being owned by significant numbers of unsophisticated investors. And to suggest that unsophisticated investors would rely, when participating in these unregulated pools, upon the expertise and bargaining power of participating sophisticated investors, rather than their own resources, merely identifies additional risks that implicate the public interest. Thus, given the risks for the financially unsophisticated, we believe **such** pools should be registered under the Act. In comparison, pools owned exclusively by sophisticated investors do not present these concerns, regardless **of** the number of investors.

## **V. Conclusion**

The Division recommends amendment of the Investment Company Act to create a new exception for funds whose securities are owned exclusively by qualified purchasers, as defined by rule. The Division also recommends that the current attribution provision in section 3(c)(1) be narrowed, and that section 3(a)(3) be amended to prevent a circumvention of the Act through investments in issuers relying on section 3(c)(1) or section 3(c)(7). Finally, the Division believes that the anti-pyramiding restrictions of section 3(c)(1) should be revised to govern all private issuers seeking to invest in the securities of registered investment companies.

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## APPENDIX 2-A

### Red-Lined Version of Proposed Amendments to the Investment Company Act of 1940

(new language is shaded, ↓ language is struck ↓)

Section 2(a) [15 U.S.C. § 80a-2(a)]. When used in this title, unless the context otherwise requires —

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(51) "Qualified purchaser" means any person whom the Commission, by rule or regulation, shall have determined not to need the protections of this title on the basis of such factors as financial sophistication, net worth, knowledge and experience in financial matters, amount of assets owned or under management, relationship with an issuer, or such other factors as the Commission may determine to be within the intent of this definition.

Section 3(a) [15 U.S.C. § 80a-3(a)]. When used in this title, "investment company" means any issuer which--

(3) is engaged or proposes to engage in the business of investing, reinvesting, owning, holding, or trading in securities, and owns or proposes to acquire investment securities having a value exceeding 40 per centum of the value of such issuer's total assets (exclusive of Government securities and cash items) on an unconsolidated basis.

As used in this section, "investment securities" includes all securities except (A) Government securities, (B) securities issued by employees' securities companies, and (C) securities issued by majority-owned subsidiaries of the owner which are not investment companies or excluded from the definition of investment company solely by virtue of section 3(c)(1) or section 3(c)(7) of the Act.

Section 3(c) [15 U.S.C. § 80a-3(c)]. Notwithstanding subsection (a), none of the following persons is an investment company within the meaning of this title:

(1) 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. Such issuer nonetheless is deemed to be an investment company for purposes of the limitations set forth in section 12(d)(1) governing the purchase or other acquisition by such issuer of any security issued by any registered investment company, and the

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~~sale of any security issued by any registered open-end investment company to any such issuer. For the purposes of this paragraph:~~

**(A)** Beneficial ownership by a company shall be deemed to be beneficial ownership by one person, except that, if such company owns 10 per centum or more of the outstanding voting securities of the issuer, and is or, but for the exception in this paragraph or paragraph (7), would be an investment company, the beneficial ownership shall be deemed to be that of the holders of such company's outstanding securities (other than short-term paper). ~~unless, as of the date of the most recent acquisition by such company of securities of that issuer, the value of all securities owned by such company of all issuers which are or would, but for the exception set forth in this subparagraph, be excluded from the definition of investment company solely by this paragraph, does not exceed 10 percentum of the value of the company's total assets. Such issuer nonetheless is deemed to be an investment company for purposes of section 12(d)(1).~~

**(B)** Beneficial ownership by any person who acquires securities or interests in securities of an issuer described in the first sentence of this paragraph shall be deemed to be beneficial ownership by the person from whom such transfer was made, pursuant to such rules and regulations as the Commission shall prescribe as necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of this title, where the transfer was caused by legal separation, divorce, death, or other involuntary event.

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**(7) Reserved.** Any issuer whose outstanding securities are owned exclusively by persons who, at the time of acquisition of such securities, are qualified purchasers. Such issuer nonetheless is deemed to be an investment company for purposes of the limitations set forth in section 12(d)(1) governing the purchase or other acquisition by such issuer of any security issued by any registered investment company, and the sale of any security issued by any registered open-end investment company to any such issuer.

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## Chapter 3

# Pooled Investment Vehicles for Employee Benefit Plan Assets

### I. Introduction and Summary of Recommendations

Over 50 million Americans have more than two trillion dollars invested in and through their employers' employee benefit plans. The assets of employee benefit plans are frequently invested in bank collective trust funds and insurance company separate accounts in which a bank or insurance company pools the assets of two or more plans to manage the assets more efficiently and to diversify the plans' investments more effectively. Although those pooled investment vehicles are functionally similar to registered investment companies, they are generally exempted from most provisions of the federal securities laws: The Division has examined these exemptions in light of numerous business and legal changes that have occurred in the pension industry in recent years and has concluded that certain of the exemptions are no longer desirable as a policy matter.

When the securities laws exceptions for pooled investment vehicles were enacted, pension plans were predominantly "defined benefit plans" offered by large and generally sophisticated employers. Employers offering defined benefit plans promise the employees a specific benefit payable upon retirement, choose the plans' investments, and bear any investment risk associated with the plans. Further, the Pension Benefit Guaranty Corporation insures defined benefit plans.<sup>2</sup> The Employee Retirement Income Security Act of 1974 ("ERISA")<sup>3</sup> is the primary law governing the activities of all retirement plans and their sponsors. ERISA

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<sup>1</sup>Section 3(a)(2) of the Securities Act of 1933 ("Securities Act") generally excepts from registration the securities issued by collective trust funds and separate accounts. Securities Act of 1933, 15 U.S.C. § 77c(a)(2). Section 3(a)(12) of the Securities Exchange Act of 1934 ("Exchange Act") exempts the securities issued by these vehicles from the registration requirements of that Act. Securities Exchange Act of 1934, 15 U.S.C. § 78c(a)(12). Section 3(c)(11) of the Investment Company Act of 1940 ("Investment Company Act") excludes these pooled investment vehicles from regulation under the Investment Company Act. Investment Company Act of 1940, 15 U.S.C. § 80a-3(c)(11).

<sup>2</sup>The PBGC safety net, alone, may not provide sufficient protection to defined benefit plan participants. See SUBCOMM. ON OVERSIGHT OF HOUSE COMM. ON WAYS AND MEANS, 102d Cong., 1st Sess., PENSION BENEFIT GUARANTY CORPORATIONS PROGRAM TO IDENTIFY, COLLECT, AND ACCOUNT FOR PREMIUM PAYMENTS 2-6 (Comm. Print 1991); Albert B. Crenshaw, *Pension Agency's Books in Disarray, Study Finds*, WASH. POST, Nov. 8, 1991, at G1.

<sup>3</sup>Employee Retirement Income Security Act of 1974, 29 U.S.C. § 1001.

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subjects plan sponsors to a range of fiduciary duties regarding the choice of plan investments depending on the type of pension plan. With respect to defined benefit plans, the plan fiduciaries have duties to choose prudently and monitor the plans' *investments*.

During the last two decades, many employers, particularly small and medium-sized employers, have offered their employees "defined contribution plans." In recent years the creation of these plans has far outpaced the creation of defined benefit plans! Defined contribution plans differ from defined benefit plans in several respects. In a defined contribution plan, an employer promises that it will set aside a specific contribution in an individual account for each employee's benefit and that each employee will receive a benefit equal to the amounts contributed to his or her account plus or minus the account's investment gains or losses. Many of these plans place the responsibility on employee-participants to direct the investment of their individual accounts.<sup>4</sup> By doing so, the investment risk associated with the investment of a pension plan falls on the employee. Fiduciaries of a participant-directed defined contribution plan have a duty to choose prudently and monitor the *investment options* available to participants, but the plan fiduciaries have no obligation to assure that participants choose suitable investments from the available options. Finally, the employee in a participant-directed defined contribution plan has no PBGC safety-net undergirding his or her choices.

While **ERISA** governs the activities of retirement plans, its disclosure regulations focus on disclosure about the plan itself and not on the investments that underlie the plans. The limited disclosure provided to plan participants about the underlying investments may have been appropriate when the employer made the investment decision and bore the investment risk. With the growth of participant-directed defined contribution plans, however, where the investment risk falls on the employee, plan participants need the same information as any other individual who invests in securities, and the focus of the securities laws needs to shift from the sponsor/employer to the participant/employee. This is

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<sup>4</sup>See EMPLOYEE BENEFITS RESEARCH INSTITUTE, EBRI ISSUE BRIEF 8, Table 3 (Oct. 1991) [hereinafter EBRI]; Phyllis Feinberg, *Changing Times for Pension Funds in the 1990s*, BARRON'S, Nov. 18, 1991, at 34.

<sup>5</sup>Craig S. Smith, *Investor Control of Retirement Funds is Rising*, Wall St. J., Jan. 31, 1992, at B4c.

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particularly so where the plan fiduciaries do not have a fiduciary obligation with respect to a participant's investment choices!

The Division has reconsidered the securities laws exemptions from two perspectives: whether employees should receive better disclosure regarding their investments, and whether the pooled investment vehicles themselves should be registered under the Investment Company Act. The Division recommends that the Commission send to Congress legislation that would remove the current exemption from registration in section 3(a)(2) of the Securities Act of 1933 ("Securities Act") for interests in pooled investment vehicles for *participant-directed defined contribution plans*. Further, the legislation would amend the federal securities laws to require the delivery of prospectuses for the underlying investment vehicles to plan participants who direct their investments. We also recommend legislation that would amend the Securities Exchange Act of 1934 ("Exchange Act") to require the delivery of semiannual and annual shareholder reports for the underlying investment vehicles (other than registered investment companies) to these plan participants. Finally, we recommend that the rules under the Investment Company Act be amended to require the delivery of semiannual and annual reports of underlying registered investment companies to these plan participants. Without these changes, plan participants will increasingly be forced to fend for themselves and make uninformed investment decisions, with the result that they may invest imprudently or too conservatively, fail to diversify their investments, and retire with inadequate assets.

The Division recommends retaining the current Securities Act exemption for interests in pooled investment vehicles for *defined benefit plans* and *defined contribution plans that do not provide for participant direction*. Since the fiduciaries of a defined benefit plan are subject to all of the fiduciary duties and liabilities under ERISA and the plans are PBGC insured, we do not believe that the additional protections of the securities laws are necessary.

Despite the general appeal of functional regulation, we do not recommend that bank collective trust funds or insurance company separate accounts containing retirement plan assets be required to register under the Investment

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<sup>6</sup>See 29 U.S.C. § 1104(c); Participant Directed Individual Account Plans, 56 FR 10724 (1991) (reproposing 29 C.F.R. § 2550.404c-1).

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Company Act of 1940 ("Investment Company Act")? Participants in plans that invest in bank collective trust funds or insurance company separate accounts are protected by other regulatory schemes, such as ERISA, banking regulations (regulation 9, the regulation of the Comptroller of the Currency governing the fiduciary powers of national banks), and state insurance laws,<sup>8</sup> diminishing the need for regulation under the Investment Company Act. Although these regulatory schemes differ, the differences do not justify altering the *status quo* and the additional costs that would result from applying the Investment Company Act to these investment vehicles.

This chapter reviews the historical justifications for the exemption of pooled investment vehicles from the securities laws and discusses recent changes in the nature of employee benefit plans (see Chronology, Appendix A). It then compares the disclosure and other requirements of the three federal regulatory schemes under which registered investment companies, bank collective trust funds, and pooled insurance company separate accounts currently operate and discusses the reasons for the Division's recommendations.

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<sup>7</sup>In connection with its proposal to modernize the financial system, the Department of the Treasury has recommended regulating banks' pooled investment activities in a manner more similar to investment companies. See U.S. DEP'T OF THE TREASURY, MODERNIZING THE FINANCIAL SYSTEM 59 (1991). We believe that we can accomplish the goals of functional regulation at the lowest cost by requiring interests in collective trust funds and separate accounts containing assets of participant-directed defined contribution plans to be registered under the Securities Act and by requiring these collective trust funds and separate accounts to provide prospectuses and shareholder reports to plan participants.

<sup>8</sup>Insurance company separate accounts are established under state law. Unless excepted by the pension plan provisions of the securities laws, separate accounts that fund variable annuities or variable life insurance are subject to the federal securities laws and thus are regulated by the Commission. While this chapter does not attempt to survey state insurance law, states provide an additional layer of protection to plan participants. For example, most states require insurance companies to insulate separate account assets from liabilities arising out of other business the company may conduct. State laws also may prescribe diversification requirements and sometimes prohibit transactions between the separate account and the insurance company. See generally Stephen E. Roth, Susan S. Krawczyk, & David S. Goldstein, *Reorganizing Insurance Company Separate Accounts under Federal Securities Laws*, 46 Bus. LAW. 537, 542-45 (1991).

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## **11. Treatment of Pooled Investment Vehicles Under the Federal Securities Laws**

### **A. Historical Treatment of Bank Collective Trust Funds**

As enacted, the Investment Company Act provided that any employees' pension, stock bonus, or profit-sharing trust which met the conditions of section **165** (now section 401) of the Internal Revenue Code ("Code") was not an "investment company."<sup>9</sup> There is no legislative history for this exclusion (originally section 3(c)(13)). The Code required, and requires now, that a pension trust be administered for the exclusive benefit of the participants, and generally that the plan assets not revert to the employer. The Code also prohibits transactions between the employer and the trust. Given these protections, the employer's incentive would be to maximize the benefits to employees and, especially in the case of defined benefit plans, minimize administrative costs. Thus, Investment Company Act protection was apparently considered unnecessary.<sup>10</sup> The Investment Company Act did not provide an exception for pooled investment vehicles in which pension plans were invested.

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<sup>9</sup>Investment Company Act of **1940**, ch. 686, § 3(c)(13), **54** Stat. **789,799** (**1940**). The provision was redesignated as section 3(c)(11) in **1970**. Investment Company Amendments Act of **1970**, Pub. L. No. **91-547**, **84** Stat. **1413** (**1970**) [hereinafter **1970** Amendments] (codified as amended at **15** U.S.C. § 80a-3(c)(11)).

Section **165** of the Code exempted from federal income tax a trust forming part of a stock bonus, pension, or profit-sharing plan of an employer for the exclusive benefit of some or all of its employees if contributions were made to the trust by such employer, or employees or both, for the purpose of distributing to such employees the earnings and principal of the fund accumulated by the trust in accordance with such plan, and if under the trust instrument it was impossible, at any time prior to the satisfaction of all liabilities with respect to employees under the trust, for any part of the corpus or income to be used for, or diverted to, purposes other than for the exclusive benefit of his employees. Revenue Act of **1938**, ch. 289, § 165, **52** Stat. **447,518** (**1938**) (codified as amended at **26** U.S.C. § **401**).

Section **401** replaced section **165** when the Internal Revenue Code of **1954** was enacted. Internal Revenue Code of **1954**, ch. 736, § **401**, **68A** Stat. **3,134** (**1954**) (codified as amended at **26** U.S.C. § **401**). Section **401** sets forth tax qualification requirements similar to those described above, and includes certain non-discrimination provisions as well as other restrictions.

<sup>10</sup>See Robert H. Mundheim & Gordon D. Henderson, *Applicability of the Federal Securities Laws to Pension and Profit-sharing Plans*, **29** L. & CONTEMP. PROBS. **795,815** (1964) [hereinafter Mundheim & Henderson]. Corporate plans that did not meet the conditions for qualification under section **165** could apply for an order exempting them from the Investment Company Act under section 6(b) of the Investment Company Act, a provision allowing the Commission to exempt employees' securities companies. **15** U.S.C. § **80a-6(b)**. See Mundheim & Henderson, *supra*, at **815-16**.

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The Securities Act had no parallel exemption for *interests* in employee benefit plans or pooled investment vehicles. The Commission's staff early on expressed the view that employee interests in pension and profit-sharing plans generally are securities, but did not require the interests in the plans to be registered under the Securities Act unless the plan provided for the purchase of the employer's stock.<sup>11</sup> The staff's early view was premised on several theories: (1) if there are no employee contributions, an interest in an employee benefit plan is the equivalent of a gift and therefore does not involve a "sale";<sup>12</sup> (2) if employee contributions are involuntary, there is no sale because there is no investment decision;<sup>13</sup> and (3) voluntary contributions are permissible so long as the contributions are not used to purchase the employer's stock (*i.e.*, the corporation does not use an employee benefit plan as an outlet for its own stock).<sup>14</sup>

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<sup>11</sup>See Ops. SEC Ass't Gen. Couns., [1941-1944 Transfer Binder] Fed. Sec. L. Rep. (CCH), ¶ 75,195 [hereinafter 1941 Opinion] (discussing the Assistant General Counsel's opinions with respect to the presence of a "security" and a "sale" in connection with an interest in certain employee benefit plans). The Assistant General Counsel also noted that exemptions from registration were available to plans that invested in employer stock under sections 3(a)(1), 3(a)(8), 3(a)(11), 3(b), and 4(1) of the Securities Act. *Id.*

Commissioner Purcell testified that the Commission had always considered pension plans that involved the sale of a security to be subject to the Securities Act. Commissioner Purcell noted that noncontributory and involuntary plans would not be subject to the Securities Act. See *Proposed Amendments to Securities Act of 1933 and the Securities Exchange Act of 1934: Hearings Before the Comm.on Interstate and Foreign Commerce, House of Representatives*, 77th Cong., 1st Sess. 892-97 (1941).

<sup>12</sup>For a discussion of the "no sale" theory and the view that there is a "sale" for value "because the employee can be deemed to have received constructively the appropriate amount of wages and tendered them back," see Martin E. Lybecker, *Bank-Sponsored Investment Management Services: A Legal History and Statutory Interpretive Analysis - Part 2*, 5 SEC. REG. L. J. 195, 227-8 (1977) [hereinafter Lybecker]. See also Mundheim & Henderson, *supra* note 10, at 807 n.39.

<sup>13</sup>Mundheim & Henderson note that the Commission's "no-sale" theory here was "not premised on the theory that the interest in the pension plan was disposed of without value or consideration in the common law sense. . . . Rather, the Commission's view is premised on the ground that there is no offer or sale in the securities laws sense because 'there is no element of volition on the part of the employees whether or not to participate and make contributions.'" Mundheim & Henderson, *supra* note 10, at 807 (quoting 1941 Opinion, *supra* note 11).

<sup>14</sup>One basis for the staff's view was a concern that the burden of preparing a registration statement in connection with the operation of a pension plan might result in many employers not allowing employees to make contributions toward their retirement. However, requiring registration where employer stock is purchased is justified because the employer would have a direct financial interest in the solicitation of the employees' contributions. Where employer stock is among the investment options, "it is not unfair to make [the employer] assume the same burdens which corporations typically assume when they go to the public for financing." *Id.* at (continued..)

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Before World War II, most retirement plans were defined benefit plans<sup>15</sup> sponsored by large corporate employers. Banks did not need to pool the assets of these large plans for efficient management.<sup>16</sup> Banking regulations governing collective investment funds, then administered by the Federal Reserve Board, permitted the use of common trust funds to pool moneys received solely for bona fide fiduciary purposes, but did not separately authorize collective trust funds for employee benefit plans.<sup>17</sup>

The number of corporate employee benefit plans increased rapidly after World War II,<sup>18</sup> and some banks pooled the assets of small employee benefit plans with their common trust funds. Apparently in response, the Federal Reserve Board amended its regulations to permit banks to invest the assets of pension, profit-sharing, and stock bonus plans collectively, provided that each

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<sup>14</sup>(...continued)

809-10. Cf. SEC v. Ralston Purina Co., 346 U.S. 119 (1953) (interpreting the nonpublic offering exemption under the Securities Act in the context of an offer of the employer's stock to a large number of employees through an employees' stock investment plan); and Form S-8, Securities Act Release No. 6867 (June 6, 1990), 55 FR 23925 (registration statement for employee benefit plans under which employees are permitted to invest their own contributions in employer stock).

<sup>15</sup>ROBERT L. CLARK & ANN A. McDERMED, THE CHOICE OF PENSION PLANS IN A CHANGING REGULATORY ENVIRONMENT 64/65/72(1990) [hereinafter CLARK & McDERMED].

"See Mundheim & Henderson, *supra* note 10, at 821.

<sup>17</sup>See Trust Powers of National Banks, 2 FR 2976 (1937)(adoption of amendments to regulation F by Federal Reserve Board); see also 24 Fed. Reserve Bull. 4-5 (1938) (common trust funds to be operated strictly for fiduciary purposes). Common trust funds allow banks to conveniently administer assets held by the bank for true fiduciary purposes and are excepted from the definition of investment company by section 3(c)(3) of the Investment Company Act. 15 U.S.C. § 80a-3(c)(3).

<sup>18</sup>A Senate subcommittee report, summarizing hearings and studies conducted by the subcommittee and its staff, attributes postwar growth in employee benefit plans to:

(1) High corporate taxes during and since World War II, coupled with the allowance of tax deductions for contributions to these programs, thus permitting their establishment at a low net cost; (2) Wage stabilization programs during and since World War II and the Korean conflict, which froze wage rates but permitted increased employee compensation in the form of these 'fringe' benefits; (3) Court decisions in the years 1948-50 which made welfare and pension matters a bargainable issue; and (4) Since 1948, the drive of labor unions to obtain welfare and pension programs. Labor spokesmen state that another reason for the development of these programs has been the inadequacy of benefits under the governmental programs.

SENATE COMM. ON LABOR AND PUBLIC WELFARE, SUBCOMM. ON WELFARE AND PENSION FUNDS, WELFARE AND PENSION PLANS INVESTIGATION, S. REP. NO. 1734, 84th Cong., 2d Sess. 12 (1956).

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such plan was exempt from federal income taxes and the collective investment was specifically authorized by the trust instrument underlying the plan or court order.<sup>19</sup> Also apparently in response, and recognizing that many employee benefit plans were too small to permit satisfactory diversification of their investments, the IRS ruled that a qualified plan may pool its funds with the funds of other qualified plans in a group trust without losing its "qualified" status under section 401 of the Code.<sup>20</sup> Under those circumstances, the group trust itself would be a qualified trust under section 401.<sup>21</sup>

The Commission's view at this time regarding the status of collective trust funds under the securities laws was unclear. By the early 1960's, the Commission interpreted the exclusion provided by section 3(c)(13) of the Investment Company Act to apply to collective trust funds.<sup>22</sup> Later in the decade, however, the staff, by "no-action" letter, took the position that interests in a collective trust fund would have to be registered under the Securities Act if the participating plans were voluntary and contributory.<sup>23</sup>

In 1962, to provide tax incentives and benefits similar to those available to corporate plans, Congress amended section 401 of the Internal Revenue Code to establish H.R. 10 ("Keogh") plans for self-employed persons and their

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<sup>19</sup>See *Collective Investment Trust Funds*, 20 FR 3305 (1955). The Federal Reserve Board did not extend to collective investment funds the restrictions in regulation F that were "designed to prevent the use of common trust funds primarily as investment vehicles." *Id.*; William P. Wade, *Bank-Sponsored Collective Investment Funds: An Analysis of Applicable Federal Banking and Securities Laws*, 35 Bus. LAW. 361,365-366 (1980). Regulation F required common trust funds to be operated only for "true fiduciary purposes," not advertised to the public as investment vehicles. *Id.* at 366 n.30; 42 Fed. Reserve Bull. 228 (1956). See also Lybecker, *supra* note 12, at 246.

<sup>20</sup>Rev. Rul. 56-267, 1956-1 C.B. 206, restated in Rev. Rul. 81-100, 1981-1 C.B. 326.

<sup>21</sup>*Id.*

<sup>22</sup>See *Common Trust Funds - Overlapping Responsibility and Conflict in Regulation: Hearings Before a Subcomm. of the House Comm. on Government Operations*, 88th Cong., 1st Sess. 7 (1963) [hereinafter *Fascell Hearings*] (statement of William L. Cary, Chairman, SEC). Wade asserts that "the justification underlying this interpretation apparently emanated from policy considerations relating to encouragement of pension plan growth, reliance on the ability of corporate plan sponsors to fend for themselves in the market place, and avoidance of overlapping jurisdiction between bank regulators and the SEC." Wade, *supra* note 19, at 377.

<sup>23</sup>See Central Bank of Montana (pub. avail. pending) (response dated Apr. 26, 1968); Safe Deposit Bank and Trust Company (pub. avail. pending) (response dated Mar. 5, 1968); Birmingham Trust National Bank Self-Employed Retirement Trust (pub. avail. pending) (response dated Mar. 4, 1968).

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employees.<sup>24</sup> Keogh plans are generally so small that pooling is necessary for their efficient management.

The Commission construed section 3(c)(13) to include Keogh plans and collective trust funds containing Keogh plan assets.<sup>25</sup> However, the Commission took a different view on registration of the *interests* in pooled investment vehicles that included Keogh plan assets under the Securities Act, because these interests would be offered to relatively unsophisticated investors who would be unable to rely on the individualized, personal contact generally viewed as an integral part of traditional fiduciary services.<sup>26</sup> The Comptroller of the Currency<sup>27</sup> opposed registration of interests in bank-sponsored pooled investment funds for Keogh plans, asserting that the exemption in section 3(a)(2) of the Securities Act for securities issued by banks applied to such interests<sup>28</sup> and that the advertising

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<sup>24</sup>Self Employed Individuals Tax Retirement Act of 1962, Pub. L. No. 87-792, 76 Stat. 809 (1962) (codified as amended at 26 U.S.C. § 401(c)).

<sup>25</sup>The status of Keogh plans under the Investment Company Act was ambiguous, turning on a convoluted and technical analysis. It was not clear whether the exclusion of section 3(c)(13) applied to them. Section 3(c)(13) referred to plans qualified under section 165 of the Internal Revenue Code of 1939 "as amended," not section 401 of the Internal Revenue Code of 1954 "as amended." Since section 401 covered the same types of *corporate* plans covered by section 165 of the 1939 Code, it seemed appropriate to treat section 3(c)(13) as though it referred to corporate plans described in section 401. Because section 165 did not provide for a Keogh-type plan, the question arose whether to read section 3(c)(13) to apply to Keogh plans authorized under amended section 401.

Then-SEC Chairman William L. Cary testified that while "we have construed the employees' pension trust exemption of section 3(c)(13) of [the Investment Company Act] to be available" to bank collective investment funds for Keogh plans, "[t]his construction was not free from doubt, for it was not certain that Congress intended to exempt anything of this nature as an employees' pension trust." *Fascell Hearings, supra* note 22, at 7 (statement of William L. Cary). The Commission could have distinguished between H.R. 10 commingled funds and collective trust funds for other section 401 plans on the basis that employer-participants in H.R. 10 commingled funds were not able to fend for themselves. See Mundheim & Henderson, *supra* note 10, at 834-36.

<sup>26</sup>See Wade, *supra* note 19, at 396; see also G.T. Lumpkin, Jr., Vice President, Wachovia Bank & Trust Co., Address Before the 44th Mid-Winter Trust Conference of the Am. Bankers Ass'n (Feb. 5, 1963), reprinted in *Fascell Hearings, supra* note 22, at 114-20 (H.R. 10 impact on trust business); Mundheim & Henderson, *supra* note 10, at 822-23.

<sup>27</sup>The power to regulate bank trust activities was transferred from the Federal Reserve Board to the Comptroller of the Currency in 1962. Act of September 28, 1962, Pub. L. No. 87-722, 76 Stat. 668 (codified as amended at 12 U.S.C. § 92a). See also Wade, *supra* note 19, at 366.

<sup>28</sup>*Fascell Hearings, supra* note 22, at 38 (statement of James J. Saxon, Comptroller of the Currency).

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restrictions in regulation 9<sup>29</sup> would address the Commission's concern that interests in the collective trust funds would be "publicly offered" for Securities Act purposes?

Chairman Cary, in testimony concerning commingled managed agency accounts, concluded that an "investor in bank sponsored mutual funds is entitled to the same protection as the investor in non-bank sponsored mutual funds."<sup>31</sup> More specifically, in reply to the Comptroller's argument that bank regulation made unnecessary the investor protections of the federal securities laws, Chairman Cary stated that banking regulation was concerned primarily with controlling the flow of credit, maintaining an effective banking structure, and protecting de ositors.<sup>32</sup> Banking regulation does not address investors' need for information?" As will be discussed below,<sup>34</sup> Congress finally resolved in favor of the Commission the issue of whether bank collective trust funds for Keogh plans should be registered under the Investment Company Act, and whether interests in those funds should be registered under the Securities Act, when it enacted the 1970 amendments to the Investment Company Act.

## B. Historical Treatment of Insurance Company Separate Accounts

In the late 1950's and early 1960's, large employers increasingly were willing to risk investing in equity securities to obtain a higher return and lessen the amount of cash required to fund their pension obligations.<sup>35</sup> The return on

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<sup>29</sup>The Comptroller adopted regulation 9 in 1963. Fiduciary Powers of National Banks and Collective Investment Funds, 28 FR 3309 (1963) (codified as amended at 12 C.F.R. § 9). As adopted, paragraph (b)(5)(iv) of regulation 9.18 restricted national banks from advertising and publicizing their collective investment funds that consisted solely of retirement, pension, profit-sharing stock bonus, or other trusts exempt from federal income tax. This restriction was eliminated in 1972. Fiduciary Powers of National Banks and Collective Investment Funds, 37 FR 24161 (1972).

<sup>30</sup>*Fascell Hearings*, *supra* note 22, at 48-50 (statement of James J. Saxon, Comptroller of the Currency).

<sup>31</sup>*Id.* at 8-9 (statement of William L. Cary).

<sup>32</sup>*SEC Legislation, 1963: Hearings on S.1642 Before a Subcommittee of the Senate Committee on Banking and Currency*, 88th Cong., 1st Sess. at 54-55 (1963) (statement of William L. Cary, Chairman, SEC).

<sup>33</sup>*See id.* at 55.

<sup>34</sup>*See infra* note 48 and accompanying text.

<sup>35</sup>Stephen B. Middlebrook & George N. Gingold, *Mass Merchandising of Equity Products by Insurance Companies*, 3 CONN. L. REV. 44/47 (1970).

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these investments, often managed by banks, was higher than that available from traditional insurance products.<sup>36</sup> To compete with the banks, insurance companies obtained state legislation allowing them to segregate premiums paid by employers from the insurance company's general reserves and invest the segregated funds in a broader and less conservative mix of securities than that normally permitted for insurance companies, with the entire investment risk of the segregated account placed on the insurance customer.<sup>37</sup>

The development of insurance company separate accounts raised the concern that insurance companies were engaging in the offer and sale of securities to the public and operating as investment companies. Ultimately, the courts held that separate accounts are subject to the requirements of the securities laws.<sup>38</sup>

To address the insurance industry's concern that it be allowed to compete with banks and other financial institutions providing investment management services on an equal footing, the Commission, in the early 1960's, adopted rules to provide exemptions for variable annuities and insurance company separate accounts that were similar to those afforded to bank products under section 3(c)(13). Rule 3c-3 under the Investment Company Act exempted from Investment Company Act regulation certain group annuity contracts held by an insurance company in a separate account.<sup>39</sup> The exemption was available only if the pension plan in connection with the group contract met the qualifications of sections 401 or 404(a)(2) of the Code. In addition, the Commission required that the group contract provide that regardless of the earnings of the separate

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<sup>36</sup>*Id.*

<sup>37</sup>*Id.* at 47-48.

<sup>38</sup>See Prudential Ins. Co. of America v. SEC, 326 F.2d 383 (3rd Cir. 1964), cert. denied, 377 U.S. 953 (1964) (insurance company separate account could be required to register under the Investment Company Act).

<sup>39</sup>Exemption of Certain Transactions of Insurance Companies, Investment Company Act Release No. 3605 (Jan. 7, 1963), 28 FR 401 (adopting rule 3c-3). In adopting rule 3c-3, the Commission noted its intention to provide relief similar to that already available to pooled investment vehicles for employee benefits maintained by banks:

Although the insurance companies may not be acting as trustees, the arrangements for utilization by employers of such special accounts maintained by insurance companies would be similar to arrangements excepted from the definition of investment company pursuant to Section 3(c)(13) of the Act, and maintained by bank trustees for the investment of funds which the employers have set aside to meet their obligations under qualified pension plans.

*Id.*

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account, the retirement benefits to employees be payable in fixed dollar amounts;<sup>40</sup> cover at least 25 employees at the time it was executed; and prohibit employee contributions to the separate account. The Commission's position seems to have been predicated on the theory that Investment Company Act protection was not necessary where a plan was large and where the risk to pay defined benefits fell on the employer.

The Commission also adopted rule 156 under the Securities Act to bring transactions exempted from Investment Company Act regulation by rule 3c-3 conditionally within the nonpublic offering exemption in the Securities Act.<sup>41</sup> Rule 156 exempted these transactions from the registration requirements, but not from the antifraud provisions, of the Securities Act. The Commission conditioned the exemption, among other things, on there being no advertising in connection with the transaction. In adopting rule 156 the Commission noted that "[i]t has been represented to the Commission that because of the variety and complexity of such contracts, they must be separately negotiated with employers who retain expert advisers, are fully informed in the matter and are in a position to fend for themselves."<sup>42</sup>

In the late 1960's, the Commission adopted rule 6e-1. While rule 3c-3 exempted a narrow class of separate accounts entirely from Investment Company Act regulation, rule 6e-1 exempted a broader class of tax-qualified insurance company separate accounts from some parts of the Investment Company Act.<sup>43</sup> A separate account exempt under rule 6e-1 was allowed to contain employee contributions. In addition, the rule required that, if the retirement plan provided for benefits which varied to reflect the investment results of the separate account, the insurance company (1) make available to participating employers sufficient copies of a written disclosure statement for all covered employees, (2) recommend to the employer that it distribute the disclosure statement to each covered employee, and (3) file the statement with the Commission. The Commission required that the disclosure statement explain that the benefits to be received by employees would vary to reflect the investment experience of the separate

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<sup>40</sup>The Commission later amended rule 3c-3 to allow group contracts to provide that retirement benefits payable to employees may vary depending on the extent of the employer's contributions. **Exemption From Certain Contracts, Investment Company Act Release No. 4007 (July 2, 1964)**' 29 FR 9433.

<sup>41</sup>See **Certain Group Annuity Contracts; Exemptions, Securities Act Release No. 4627 (Aug. 1, 1963)**, 28 FR 8208 (adopting rule 156 under the Securities Act).

<sup>42</sup>*Id.*

<sup>43</sup>See **Certain Separate Accounts of Insurance Companies, Investment Company Act Release No. 5741 (July 15, 1969)**, 34 FR 13019 (adopting rule 6e-1 under the Investment Company Act and conforming amendments to rule 156 under the Securities Act).

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account, and that the assets held in the account would include common stocks and other equity investments.

### C. Current Securities Laws Exemptions for Pooled Investment Vehicles

Congress's amendments to the Investment Company Act in 1970 included the current exemptions from the securities laws for bank collective trust funds and insurance company separate accounts holding retirement plan assets.<sup>44</sup> The amendments to section 3(c)(13) (which was renumbered section 3(c)(11)) essentially codified existing Commission positions with respect to collective trust funds<sup>45</sup> and provided a "level playing field" between banks and insurance companies that managed employee benefit plans assets through pooled investment vehicles.<sup>46</sup> At the same time, Congress amended section 3(a)(2) of the Securities Act to exempt certain interests in collective trust funds and insurance company separate accounts for tax-qualified plans from registration under the Securities Act.<sup>47</sup> Interests issued by these pooled investment vehicles remain subject to the antifraud provisions of the Securities Act. The amendments to section 3(a)(2) also codified the Commission's position requiring registration of interests in Keogh plans, pooled investment vehicles for Keogh plans,<sup>48</sup> and plans under which employee contributions are permitted to be invested in securities issued by the employer.

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<sup>44</sup>1970 Amendments, supra note 9 (codified as amended at 15 U.S.C. § 80a-3(c)(11)).

<sup>45</sup>See supra Section II.A. Many banks had relied on no-action relief under section 3(c)(13) of the Investment Company Act and the intrastate exemption in section 3(a)(11) of the Securities Act. Lybecker, supra note 12, at 235, n.107; Mundheim & Henderson, supra note 10, at 830, n.114.

<sup>46</sup>HOUSE COMM ON INTERSTATE AND FOREIGN COMMERCE, INVESTMENT COMPANY AMENDMENTS ACT OF 1970, H.R. REP. NO. 1382, 91st Cong., 2d Sess. 10, 18 (1970) [hereinafter REPORT NO. 1382]. In connection with these amendments, the Commission rescinded rules 3c-3 and 6e-1 under the Investment Company Act and rule 156 under the Securities Act. See Registration and Regulation of Insurance Company Separate Accounts, Investment Company Act Release No. 6430 (April 2, 1971), 36 FR 7897.

<sup>47</sup>1970 Amendments, supra note 9 (codified as amended at 15 U.S.C. § 77c(a)(2)).

<sup>48</sup>Although Keogh plans are qualified under section 401 of the Internal Revenue Code, Congress did not exempt interests in collective trust funds for Keogh plans from Securities Act registration, in part because of the likelihood that these securities would be sold to unsophisticated employers. REPORT NO. 1382, supra note 46, at 44. Instead, Congress gave the Commission rulemaking authority in section 3(a)(2) to exempt interests in these pooled investment vehicles under certain circumstances. See *infra* note 68 and accompanying text (Commission adopted rule 180 exempting from registration certain Keogh plans and their pooled investment vehicles).

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Congress intended these amendments to respond to concerns expressed by both the banking and insurance industries that the lack of a clear exemption under the Securities Act for interests in pooled investment vehicles might expose banks and insurance companies to civil liability under the Securities Act.<sup>49</sup> Congress exempted these vehicles, in part, because they were subject to regulation under other provisions of law.<sup>50</sup> Congress assumed, however, that the person making the investment decisions for a plan, whether it was the sponsoring employer or a professional investment manager, was a sophisticated investor able to fend for itself and the plan participants with the application of only the Securities Act's antifraud provisions.<sup>51</sup>

The Commission generally supported the 1970 legislation extending the existing exemptions for qualified employee benefit plans to bank collective trust funds consisting solely of the assets of those plans.<sup>52</sup> In this connection, the Commission sought and retained the authority under section 3(a)(2) of the Securities Act to require registration of interests in single and collective trust funds for Keogh plans and interests in plans that invest employee contributions in employer securities. At the same time, the Commission opposed the legislation giving similar exemptions for insurance company separate accounts and interests therein. The Commission recognized that amending the Securities Act and Investment Company Act to exempt only the collective trust funds might give the banks an advantage over the insurance companies in competing to manage pension assets, but justified its position on the grounds that banks were already subject to more extensive regulation, by federal and state banking regulators, than were the insurance companies.<sup>53</sup> The Commission would have preferred to

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<sup>49</sup>See Employee Benefit Plans; Interpretation of Statutes, Securities Act Release No. 6188 (Feb. 1, 1980), 45 FR 8960 (interpretive release on the treatment of employee benefit plans under the securities laws); Mundheim & Henderson, *supra* note 10, at 822.

<sup>50</sup>See REPORT NO. 1382, *supra* note 46, at 10.

<sup>51</sup>See *id.* at 43-44.

<sup>52</sup>See Mutual Funds Legislation of 1967: Hearing on Amendment No. 438 to S. 1659 Before the Senate Committee on Banking and Currency, 90th Cong., 1st Sess. 1326-27 (1967) [hereinafter 1967 Senate Hearings] (statement of Manuel F. Cohen, Chairman, SEC); cf. Investment Company Act Amendments of 1967 -- Bank and Insurance Company Collective Investment Funds and Accounts: Hearings on H.R. 14742 Before the Subcommittee on Commerce and Finance of the House Committee on Interstate and Foreign Commerce, 90th Cong., 2d Sess. 115, 117-18, 133 (1968) [hereinafter 1968 House Hearings] (statement of Manuel F. Cohen, Chairman, SEC) (supporting extension of Investment Company Act exception to collective trust funds but opposing blanket exemption from Securities Act).

<sup>53</sup>See Letter from Hamer H. Budge, Chairman, SEC to Senator John J. Sparkman (Apr. 29, 1969) reprinted in Investment Company Amendments Act of 1969: Hearings on S. 34 and S. 296 Before the Senate Committee on Banking and Currency, 91st Cong., 1st Sess. 31-33 (1969) [hereinafter Budge (continued..)]

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retain jurisdiction over insurance company separate accounts for employee benefit plan assets and to use its rulemaking authority to exempt separate accounts from some provisions of the Investment Company Act.<sup>54</sup>

Four years after the 1970 amendments, Congress enacted ERISA to provide comprehensive minimum standards for the administration of private employee benefit plans.<sup>55</sup> While ERISA was a response to the growth in size, scope, and number of corporate employee benefit plans, and their increasing importance to employees and to the economy as a whole, ERISA also authorized the establishment of Individual Retirement Accounts ("IRAs").<sup>56</sup> The new provisions permitted individuals not covered by an employer or government plan to establish, and make deductible contributions to, their own IRA. IRAs do not meet the requirements for qualification under section 401 of the Code and accordingly, virtually from the time of their creation, the staff has taken the position that the exception in section 3(c)(11) is not available to bank collective funds that pool IRA assets or commingle the assets of IRAs with corporate plans qualified under section 401 of the Code.<sup>57</sup> The staff did not believe that the historical justifications for the exemptions for pooled investment vehicles for employee benefit plans could support exempting pooled vehicles for IRAs, since the participants generally would be less able to fend for themselves than even the self-employed participants in Keogh plans.

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<sup>53</sup>(...continued)  
Letter]; *1968 House Hearings*, *supra* note 52, 137 (statement of Manuel F. Cohen); *1967 Senate Hearings*, *supra* note 52, at 1334-35 (statement of Manuel F. Cohen).

<sup>54</sup>Budge Letter, *supra* note 53; *1967 Senate Hearings*, *supra* note 52, at 133435 (statement of Manuel F. Cohen).

<sup>55</sup>Employee Retirement Income Security Act of 1974, Pub. L. No. 93-406, 88 Stat. 829 (1974) (codified as amended at 29 U.S.C. § 1001).

<sup>56</sup>*Id.* at § 2002(b), 88 Stat. at 959 (1974) (codified as amended at 26 U.S.C. § 408).

<sup>57</sup>See, e.g., Santa Barbara Bank and Trust (pub. avail. Nov. 1, 1991); United Missouri Bank of Kansas City, N.A. (pub. avail. Dec. 31, 1981); Continental Illinois National Bank & Trust Co. of Chicago (pub. avail. April 28, 1975).

The staff believes that pooled funds for IRAs require the protection of both the Securities and Investment Company Acts in part because interests in them would be offered to the general public as investments, not simply because IRAs are authorized under section 408 instead of section 401. Cf. Continental Illinois National Bank & Trust Co. of Chicago, *supra*.

The fact that a collective trust fund for IRAs is not excepted from the provisions of the securities laws has been explicitly recognized by Congress. See SUBCOMM ON SECURITIES OF THE SENATE COMM. ON BANKING, HOUSING AND URBAN AFFAIRS, STUDY OUTLINE: THE SECURITIES ACTIVITIES OF COMMERCIAL BANKS, 94th Cong., 1st Sess. 13 (1975).

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Congress created the 401(k) plan, now the most popular type of defined contribution plan, by amending section 401 of the Code in 1978.<sup>58</sup> This amendment exempted from taxation certain profit-sharing and stock bonus plans that allowed employees to elect to receive, as part of their taxable income, the employer's contribution or, instead, defer receipt of, and taxation on, the contribution. If the employee elected to defer receipt of the contribution, it would be invested in a trust where the contributions and the earnings thereon would accumulate tax-free until disbursed.

The Supreme Court, in 1979, held that participant interests in involuntary, noncontributory pension plans are not securities under the Securities Act and the Exchange Act.<sup>59</sup> Subsequently, the Commission issued two major interpretive releases clarifying the treatment under the Securities Act of employee benefit plans not covered by the Supreme Court's decision.<sup>60</sup> These releases repeated the longstanding position that an employee's interest in a corporate pension or profit-sharing plan falls within the Securities Act's definition of "security" if the plan is both voluntary and contributory, but that registration is required only if the plan permits employee contributions to be invested in employer securities!<sup>61</sup> The Commission did not require interests in other plans to be registered for two reasons: (1) participants generally do not make investment decisions for an involuntary plan, and (2) the Commission did not wish to impose on an employer the cost of registering the interests in a plan except where the employer had a direct financial interest in soliciting voluntary employee contributions, such as where employee contributions are used to purchase the employer's securities.<sup>62</sup> At this time, 401(k) plans were funded entirely by employer contributions. Accordingly, the staff took the position that 401(k) plans were noncontributory and that, therefore, interests in 401(k) plans were not subject to the Securities Act.<sup>63</sup>

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<sup>58</sup>Revenue Act of 1978, Pub. L. No. 95-600, § 135, 92 Stat. 2763, 2785-87 (1978) (codified as amended at 26 U.S.C. § 401(k)).

<sup>59</sup>International Brotherhood of Teamsters v. Daniel, 439 U.S. 551 (1979).

<sup>60</sup>Employee Benefit Plans, Securities Act Release No. 6281 (Jan. 15, 1981), 46 FR 8446 (supplemental release on application of Securities Act to employee benefit plans); Sec. Act Rel. 6188, *supra* note 49 (stating staff's position on application of Securities Act to employee benefit plans).

<sup>61</sup>Sec. Act Rel. 6188, *supra* note 49.

<sup>62</sup>*Id.* See Lybecker, *supra* note 12, at 230. Interests in plans that are required to be registered generally are registered on Form S-8, a simplified registration form that now allows a registrant to incorporate certain ERISA disclosure documents by reference. The form is available to reporting companies. See Sec. Act Rel. 6867, *supra* note 14.

<sup>63</sup>Sec. Act Rel. 6281, *supra* note 60.

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Congress revisited the securities law exclusions for bank and insurance company pooled investment vehicles in 1980 in relation to governmental plans. It amended the securities laws to exclude interests in single and pooled governmental plans from registration under both the Securities Act and the Exchange Act, and governmental plans and their pooled investment vehicles from regulation under the Investment Company Act.<sup>64</sup>

In 1981, the Internal Revenue Service issued rules under section 401(k) of the Code, allowing plans to provide for pre-tax "out-of-pocket" employee contributions through salary reduction.<sup>65</sup> The Commission staff subsequently stated that interests in 401(k) plans that permit employees to contribute voluntarily a portion of their compensation would be **securities**.<sup>66</sup> Although a salary reduction 401(k) plan would involve the issuance of a security, registration of the interests in a 401(k) plan generally would not be required unless employee contributions are permitted to be invested in employer stock.<sup>67</sup>

The last major action affecting the employee benefit exceptions occurred in 1981 when the Commission adopted rule 180.<sup>68</sup> The rule conditionally exempts an interest in a Keogh plan, and the plan's interest in a pooled investment vehicle, from Securities Act registration on the basis of the financial sophistication of the sponsoring employer or on the employer's use of an independent professional manager.

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<sup>64</sup>Small Business Investment Incentive Act of 1980, Pub. L. No. 96-477, §§ 701-03, 94 Stat. 2275, 2294-96 (1980) (codified at 15 U.S.C. §§ 77c(a)(2)(C) (Securities Act § 3(a)(2)(C)), 78c(a)(12)(C) (Exchange Act § 3(a)(12)(C)), 80a-3(c)(11) (Investment Company Act § 3(c)(11))).

<sup>65</sup>See Certain Cash or Deferred Arrangements Under Employee Plans, 46 FR 55544 (1981) (notice of proposed rulemaking); Income Tax; Taxable Years Beginning After December 31, 1953 and OMB Control Numbers Under the Paperwork Reduction Act; Certain Cash or Deferred Arrangements Under Employee Benefit **Plans**, 53 FR 29658 (1988) (final regulations, codified as amended at 26 C.F.R. § 1.401k-1. See generally Curtis Vosti, *Creator Faced Long Struggle, PENSIONS & INVESTMENTS*, Oct. 28, 1991, at 17 (establishment of 401(k) plans that allow employees to make pre-tax contributions).

<sup>66</sup>See 1 Pens. Plan Guide (CCH) ¶ 1112 (Dec. 7, 1990); Diasonics, Inc. (pub. avail. Nov. 29, 1982).

<sup>67</sup>Diasonics, Inc., supra note 66.

<sup>68</sup>Exemption From Registration of Interests and Participations Issued in Connection With Certain H.R. 10 Plans, Securities Act Release No. 6363 (Nov. 24, 1981), 46 FR 58287 (codified at 17 C.F.R. § 230.180).

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## **111. Recent Developments in the Employee Benefit Plan Industry**

The 1980's witnessed a marked shift toward the establishment of defined contribution plans among employers, although defined benefit plans still contain the majority of retirement plan assets.<sup>69</sup> As noted above,<sup>70</sup> under a defined benefit plan, the employer is obliged to pay retirement benefits of specified amounts to employees meeting the plan's eligibility and vesting requirements. Defined contribution plans only obligate an employer to make contributions to the participant's account in the plan. The retirement benefits the employee receives will depend on the amount of assets in his or her account at retirement.<sup>71</sup> In a defined benefit plan, the employer bears the investment risk of ensuring that there are sufficient assets to meet the plan's obligations;<sup>72</sup> in a defined contribution plan, the investment risk falls upon the plan participants.

### **A. Increase in Number of Defined Contribution Plans**

Defined benefit plans continue to be the primary type of private pension plan, covering more workers and containing more assets than defined contribution plans. During the past decade, however, the number of defined contribution plans has grown dramatically and the number of defined benefit plans has decreased correspondingly, especially among mid-sized employers.<sup>73</sup> Defined contribution plans constitute 81% of all pension plans (see Figure 3-1).<sup>74</sup>

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<sup>69</sup>See PENSION BENEFIT GUARANTY CORPORATION, PENSION PLAN CHOICE, 1979-1987: CLARIFICATIONS AND EXTENSIONS (1990) [hereinafter PBGC STUDY]; CLARK & McDERMED, *supra* note 15.

<sup>70</sup>See *supra* pp. 1-2.

<sup>71</sup>See 29 U.S.C. § 1002(34) (definition of defined contribution plan).

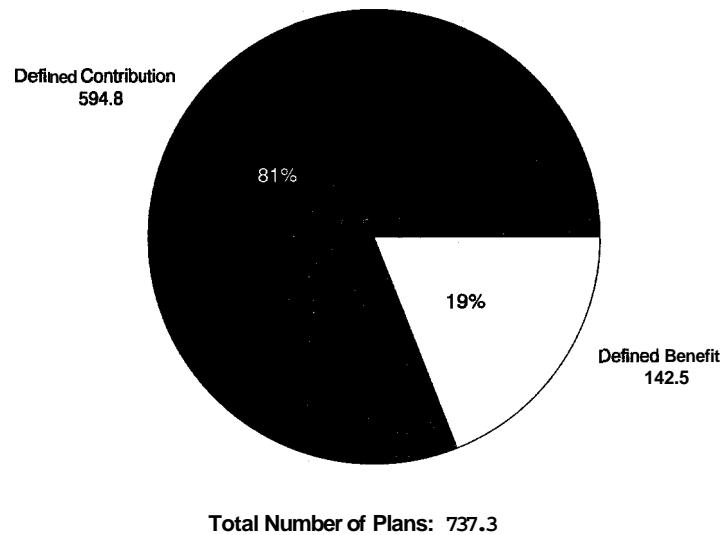
<sup>72</sup>See 29 U.S.C. § 1002(35) (definition of defined benefit plan).

<sup>73</sup>Approximately 51 million workers, 55% of the full-time labor force, will be covered by a private retirement plan (either defined benefit or defined contribution) at the end of 1991. The coverage rate for employees in smaller firms is lower. Less than 25% of small employers provide retirement benefits. Frank Swoboda, *White House Proposes New Pension Laws*, WASH. POST, May 1, 1991, at F1.

<sup>74</sup>EBRI, *supra* note 4, at 8, Table 3. Defined contribution plans constitute 83% of pension plans covering fewer than 100 participants. See *id.*

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**FIGURE 3-1**  
**Total Number of Pension Plans in 1988**  
(thousands)



Source: Employee Benefits Research Institute

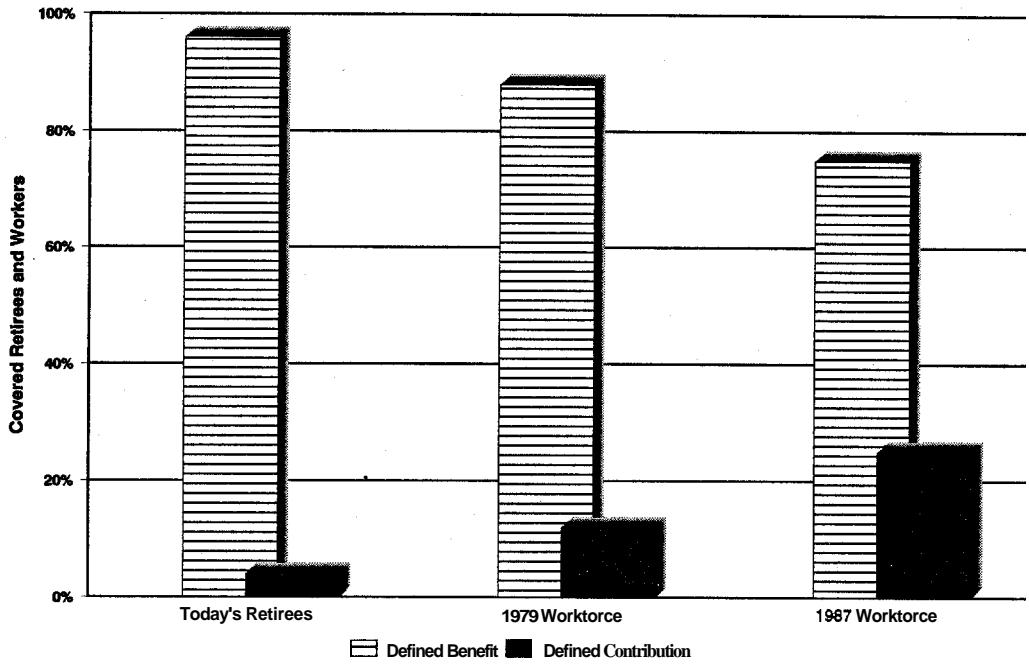
Among retired workers currently receiving pensions, 96% were participants in defined benefit plans, while only 4% were participants in defined contribution plans.<sup>75</sup> Moreover, while 88% of all workers covered by a retirement plan in 1979 were covered by a defined benefit plan, by 1987 only 75% of those covered were under a defined benefit plan (see Figure 3-2).<sup>76</sup>

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<sup>75</sup>U.S. GENERAL ACCOUNTING OFFICE, PRIVATE PENSIONS MILLIONS OF WORKERS LOSE FEDERAL BENEFIT PROTECTION AT RETIREMENT 4-5 (1991).

<sup>76</sup>PBGC STUDY, supra note 69, at 2. By contrast, the study notes that the portion of workers covered primarily by a defined benefit plan was relatively stable during the period from 1960 to 1980. Id. See generally CLARK & McDERMED, supra note 15, at 81-90 (data from 1977-85 show increasing use of defined contribution plans as primary pension plan among employers of all sizes, especially smaller employers).

**FIGURE 3-2**  
**Growing Role of Defined Contribution Plans**



Source: U.S. General Accounting Office  
 Pension Benefit Guaranty Corp

Analysts attribute the change to a variety of factors, including: changes in employment patterns, which have resulted in greater numbers of workers employed by smaller firms;<sup>77</sup> the authorization of the 401(k) plan in 1978; the increased administrative costs associated with operating a defined benefit plan, particularly for smaller plans;<sup>78</sup> and the importance to employers of being able

<sup>77</sup>See James B. Lockhart, *PBGC Advocates Defined-Benefit Plan Growth*, PENSION WORLD, Feb. 1990, at 38/40 (noting that "more people are working for smaller and/or service sector employers, who are inclined to establish defined-contribution plans"). However, changing employment patterns appear to account for only 20% of the shift in plan choice. See PBGC STUDY, *supra* note 69, at 1, 5. The PBGC STUDY also notes that 70% of the switch to 401(k) plans is "attributable to firms that otherwise would have been more likely to have chosen defined-benefit plans." *Id.* at 19. See also CLARK & McDERMED, *supra* note 15, at 91.

<sup>78</sup>See PBGC STUDY, *supra* note 69, at 1. See also Peter F. Drucker, *Reckoning with the Pension Fund Revolution*, HARV. BUS. REV., Mar.-Apr. 1991, at 106,112 (poor investment performance and new accounting standards for underfunding mean that employers will move away from defined benefit plans). But see Barry B. Burr, *Reckoning with Myths of Drucker*, PENSIONS & INVESTMENTS, May 13, 1991, at 12 (disputing Drucker's assertions about investment performance of defined benefit plans). An employer must report unfunded defined benefit plan obligations as a liability  
 (continued...)

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to predict and control liabilities more accurately with defined contribution plans.<sup>79</sup>

## B. Growth of 401(k) Plans

The popularity of one particular type of defined contribution plan -- the 401(k) plan -- is a major cause of the growth of defined contribution plans relative to defined benefit plans.<sup>80</sup> Many employers, large and small, are establishing these plans.<sup>81</sup> There are many reasons why 401(k) plans are the fastest growing form of defined contribution plan. Employers like 401(k) plans because the employees contribute through salary reduction, which lowers the employers' cost of providing retirement benefits. In addition, employers believe that a 401(k) plan helps to attract and retain employees.<sup>82</sup> Like other defined contribution plans, the employer's 401(k) cost of complying with ERISA is lower, the employees bear the investment risk, and the employer can more easily predict its future liability.<sup>83</sup> Employees like 401(k) plans because they can make voluntary *pre-tax* contributions to a plan, taxes are deferred on employees' earnings under a plan, and their employers usually match a percentage of their contributions, thereby instantly increasing the employees' retirement savings. Employees further like that they are able to exert some control over how their 401(k) plan contributions are invested.<sup>84</sup> These plans are also attractive to employees because the assets

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<sup>78</sup>(...continued)

on its balance sheet. See EMPLOYERS' ACCOUNTING FOR PENSIONS, Statement of Financial Accounting Standards No. 87, § 36 (Fin. Accounting Standards Bd. 1985).

<sup>79</sup>INVESTMENT COMPANY INSTITUTE, PERSPECTIVE ON MUTUAL FUND ACTIVITY: HOLDING THE COURSE (Fall 1991) at 17-18. See also Daniel H. Jackson & William J. McDonnell, *What's Behind the Switch to Defined Contribution Plans?*, PENSION WORLD, Aug. 1990, at 40, 41 [hereinafter Jackson & McDonnell].

<sup>80</sup>See PBGC STUDY, *supra* note 69, at 13-22; Feinberg, *supra* note 4, at 34; Curtis Vosti, *401(k) 'Clarification'* a *Crossroads*, PENSIONS & INVESTMENTS, Oct. 28, 1991, at 17 [hereinafter 401(k) Clarification].

<sup>81</sup>See Feinberg, *supra* note 4, at 36; Henry von Wodtke and Nancy Sabatiel, *401(k) Keeps Status as America's Favorite Employee Benefit*, PENSION WORLD, Nov. 1991, at 14 [hereinafter Wodtke & Sabatiel; *401(k) Clarification*, *supra* note 80].

<sup>82</sup>See PBGC STUDY, *supra* note 69, at 14/16; Wodtke & Sabatiel, *supra* note 81, at 14; Peter Starr, *Competitive 401(k) Plans*, PENSION WORLD, Apr. 1991, at 48.

<sup>83</sup>See generally Richard N. Pallan, *Defined Responsibility Should Follow Popularity of Retirement Plans*, PENSION WORLD, Dec. 1991, at 34; Feinberg, *supra* note 4, at 34, 36.

<sup>84</sup>See Wodtke & Sabatiel, *supra* note 81, at 15; *401(k) Clarification*, *supra* note 80, at 17; Starr, *supra* note 82.

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in the plan are "portable," the participant can more easily ascertain his or her account balance, and many plans allow a participant to borrow from the account.<sup>85</sup>

According to estimates, **401(k)** plans now have nearly \$300 billion in assets and continue to grow rapidly.<sup>86</sup> A recent survey found that 82% of participants in **401(k)** plans decide how their own contributions are to be invested and 54% of participants decide how their employers' contributions are to be invested.<sup>87</sup>

### C. Growth in Defined Contribution Plan Assets

Available statistics show that defined contribution plans represent a growing portion of the nation's retirement plan assets. The proportion of assets invested in defined contribution plans has grown steadily since the mid-1970s. Defined contribution plan assets grew from 28% of total private pension assets in 1975 to 39% in 1988 (see Figure 3-3).<sup>88</sup>

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<sup>85</sup>See Feinberg, *supra* note 4, at 34/38; Jackson & McDonnell, *supra* note 79, at 41; Starr, *supra* note 82. See also Sheldon R. Barker, *In Pursuit of 401(k) Dollars: A Billion Here; A Billion There; Pretty Soon You are Talking Real Money*, FUNDS AGENTS CUSTODIANS SUPPLIERS, Summer 1991, at 7-8.

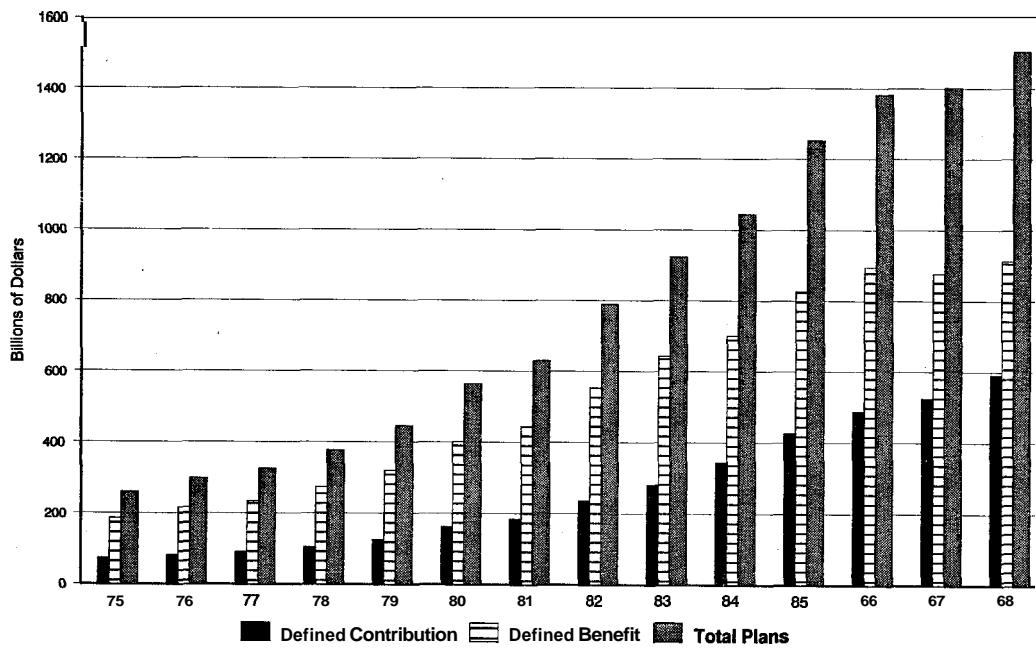
Defined contribution plans increasingly are used by participants as a means of general purpose investment. Most employees who obtain lump sum payments of their **401(k)** plan accounts when they change jobs spend the money rather than place it in another retirement account. See Department of Labor Press Release No. 91-200 (Apr. 30, 1991); Swoboda, *supra* note 73, at F2. Many participants view their **401(k)** plan as a means of saving for needs other than retirement, even though the **401(k)** plan may be the only employer-sponsored source of retirement income for increasing numbers of employees. See Jackson & McDonnell, *supra* note 79, at 41. In this respect, defined contribution plan investment vehicles compete with investments that are available to investors outside of their retirement plans.

<sup>86</sup>See Barker, *supra* note 85, at 7; Bill Montague, *401(k)s Offer Options Gain Appeal*, USA TODAY, May 20, 1991, at 3B; Joel Chernoff, *New Rule Increases Flexibility*, PENSIONS & INVESTMENTS, Dec. 24, 1990, at 30.

<sup>87</sup>PROFIT SHARING COUNCIL OF AMERICA, 34TH ANNUAL SURVEY OF PROFIT SHARING AND 401(K) PLANS 15 (1991). The survey also found that 74% of plan participants who make after-tax contributions direct the investment of their contributions. *Id.*

<sup>88</sup>PENSION AND WELFARE BENEFITS ADMIN., U.S. DEP'T OF LABOR, TRENDS IN PENSIONS 1991 (John A. Turner & Daniel J. Beller, eds., forthcoming 1992) [hereinafter PWBA] (manuscript at Table 16.11, on file with Division).

**FIGURE 3-3**  
**Pension Plan Assets By Type of Plan 1975-88**



Source: Pension & Welfare Benefits Admin.

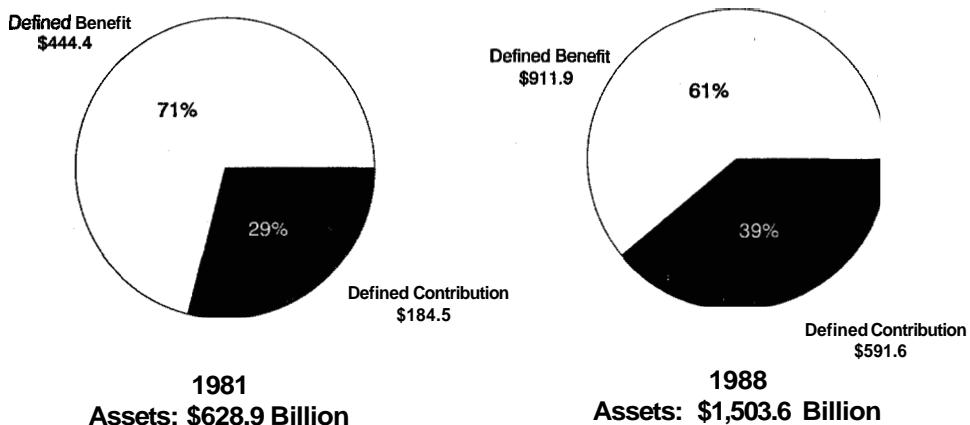
Most of this growth has occurred since 1981,<sup>89</sup> the first year the IRS allowed pre-tax contributions by employees through salary-reduction (see Figure 3-4).<sup>90</sup>

<sup>89</sup>*Id.*

<sup>90</sup>See supra note 65 and accompanying text.

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**FIGURE 3-4**  
**Comparison of Pension Plan Assets 1981 vs. 1988**



Source: Pension & Welfare Benefits Admin.

The vast majority of all private pension plans existing in 1988 covered a single employer with fewer than 100 participating employees.<sup>91</sup> Defined contribution plans are overwhelmingly the pension plan of choice for smaller employers as evidenced by 77% of their assets being invested in defined contribution plans (see Figure 3-5).<sup>92</sup>

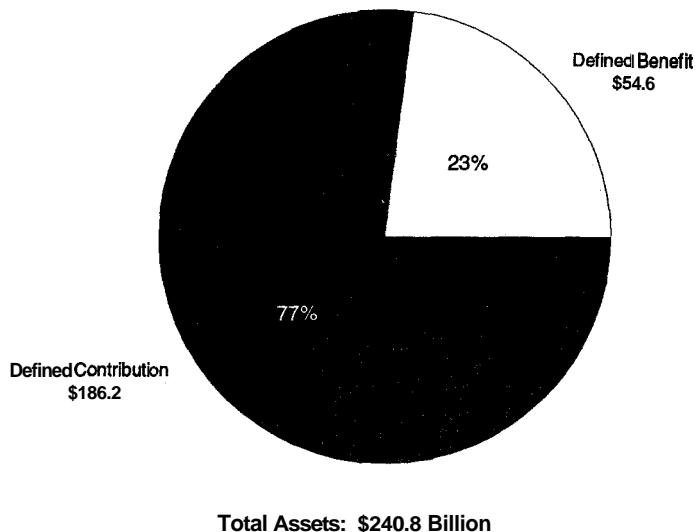
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<sup>91</sup>EBRI, *supra* note 4, at 7.

<sup>92</sup>PWBA, *supra* note 88.

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**FIGURE 3-5**  
**1988 Pension Plan Assets**  
**Small Plans**



Source: Pension & Welfare Benefits Admin.

#### **D. Competition Among Mutual Funds, Banks, and Insurance Companies**

The trend toward greater participant direction of defined contribution plan accounts has intensified competition among mutual funds, banks, and insurance companies for the management of retirement plans, especially 401(k) plan assets (see Table 3-1).<sup>93</sup>

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<sup>93</sup>Banks, insurance companies, and mutual funds compete for market share by emphasizing, where relevant, differences in investment performance and expertise in management, the security of assets underlying the investments offered, recordkeeping services, "one-stop shopping" for combined services, or participant services such as daily valuation and telephone switching. See Diane Levick, *Insurance Companies, Banks, Mutual Funds Vie*, HARTFORD COURANT, Oct. 8, 1990; see also Curtis Vosti, *Adapting to Change*, PENSIONS & INVESTMENTS, Sept. 30, 1991, at 1 (banks and mutual funds offer innovative services and new investment strategies to attract 401(k) plan investments). Some fund management groups have set up registered investment companies specifically for the assets of qualified plans.

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**Table 3-1**  
**Total Pension Plan Assets (billions) in Pooled Vehicles, 1990**

bank collective trust funds	\$267
insurance company separate accounts	\$135
mutual funds	\$ 36

Sources: Employee Benefit Research Institute, American Council of Life Insurance, Investment Company Institute

As evidence of the increased competition for defined contribution plan assets, a recent survey of the 100 largest U.S. bank and trust corporations found that many banks and trusts offer services to 401(k) plan clients comparable to those provided by mutual funds, including daily valuation and a variety of investment products.<sup>94</sup> Eighty-five percent of the banks and trust companies responding to the survey offer collective investment funds and "slightly more than half" offer mutual funds. *Of* those that offer mutual funds, sixty-eight percent offer proprietary funds (*i.e.*, funds available only to the banks' customers). The consultant that conducted the survey expressed the view that "the trend toward proprietary mutual funds is due to client [*i.e.*, the plan sponsor or administrator] demand for daily valuation."<sup>95</sup> The survey also noted that banks and trust companies increasingly are offering computerized "on-line" services to their 401(k) plan clients.<sup>96</sup>

#### **IV. Information Provided to Investors**

As discussed above,<sup>97</sup> employees increasingly participate in defined contribution plans, and increasingly make their own investment decisions regarding the assets in these plans. These changes eviscerate the original rationale for the exemptions from securities disclosure requirements for pooled

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<sup>94</sup>OPTIMA GROUP, INC., NATIONAL 401(K) MARKETING TRENDS 9 (1990).

<sup>95</sup>*Id.*

<sup>96</sup>*Id.* at 10.

<sup>97</sup>See supra Section III.

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investment vehicles -- that large employers, making the investment decisions and bearing the investment risks, could obtain needed information without disclosure requirements.

Another possible rationale for these exemptions is that they are unnecessary in light of the other federal regulations now applicable to pension plans and their pooled investment vehicles. As this section shows, however, these regulations do *not* ensure that participants in defined contribution plans receive the information they would receive under the federal securities laws, or the information they need to make informed investment decisions.

## A. Comparison of Disclosure and Reporting Requirements

Investment companies, bank collective trust funds, and insurance company separate accounts are each subject to distinct disclosure and reporting requirements. These schemes of regulation are described below.

### 1. Prospectuses; Written Plans

An investment company must register itself under the Investment Company Act and the securities it issues under the Securities Act. The disclosures required under the securities laws as a result of registration include a prospectus which contains information about the fund's fundamental investment objectives and policies; performance information covering ten years; information about the investment manager's background and compensation; how to purchase and redeem shares; and a table summarizing the fund's fees and expenses and their effect on a shareholder's investment. Section 5 of the Securities Act requires that a copy of the prospectus precede or accompany any security sold.

Under the Securities Act, an investment company sponsor offering shares in an investment company can be sued for damages if the registration statement is materially misleading or defective,<sup>98</sup> if the sponsor fails to deliver a prospectus in connection with the sale of a security,<sup>99</sup> or if the sponsor or its employees offer or sell any security by means of a prospectus or oral communication that includes a material misstatement or omission.<sup>100</sup> The investment company's underwriter and board of directors are also liable under section 11 of the Securities Act for a materially misleading or defective registration statement. In addition, a shareholder can bring an action for fraud

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<sup>98</sup>Securities Act § 11, 15 U.S.C. § 77k.

<sup>99</sup>Securities Act § 12(1), 15 U.S.C. § 77l(1).

<sup>100</sup>Securities Act § 12(2), 15 U.S.C. § 77l(2).

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under rule 10b-5 of the Exchange Act in connection with the purchase or sale of an investment company's securities.

ERISA disclosure requirements focus primarily on information about the plan itself, rather than on detailed information about the vehicles that fund the plan. Under ERISA, participants must receive a Summary Plan Description that must be updated periodically if material changes occur in the plan.<sup>101</sup> The Summary Plan Description summarizes the participants' rights and obligations under a plan, including the plan's eligibility and vesting provisions, procedures for presenting benefits claims, and the method by which contributions to the plan are determined. With respect to the plan's investments, the Summary Plan Description is required to include only the identity of any investment vehicles in which the plan invests.<sup>102</sup> Thus, ERISA does not require a plan's investment vehicles to provide disclosure to the plan fiduciaries or participants nearly comparable to that provided to investors by investment companies or other issuers under the federal securities laws. With respect to participant-directed plans, while employers currently make available information about investment vehicles to participants in a number of ways, the participant must take the initiative to obtain the information; ERISA does not require the plan fiduciaries or the employer to furnish participants with information about their investments.<sup>103</sup>

Recently proposed regulations of the Department of Labor, if adopted, would shift even greater responsibility for investment decisions from the plan fiduciaries to the employees and heighten participants' need for information.<sup>104</sup>

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<sup>101</sup>29 U.S.C. §§ 1022(a)(1), 1024(b).

<sup>102</sup>See 29 U.S.C. § 1022; 29 CFR. § 2520.102-3. Indeed, some commentators advocate providing plan participants with the least information possible. One writer has suggested that, with respect to underperforming 401(k) plans, "it makes sense not to name the mutual fund, or investment advisor used for the investment choices. Use generic terms: equity fund, fixed fund, balanced fund. That way, changes can be made behind the scenes without upsetting the employees." Renee Brody Levow, *How to Get Your Employees to Love You and Their 401(k)*, PENSION WORLD, Aug. 1990, at 39. This abbreviated disclosure apparently would not satisfy ERISA's requirement that the Summary Plan Description identify the plan's investment vehicles.

<sup>103</sup>Employers may make available information to employees by providing a prospectus, if one is available and if requested by a participant; through "on-line" computerized information services; through other written materials; by use of a bulletin board; or by referring participants to other sources of information. See generally Julie Rohrer, *The Communications Cloud Over 401(k)s*, INSTITUTIONAL INVESTOR, Sept. 1991, at 189 (increasing need for information about investment options).

<sup>104</sup>The Department of Labor first proposed rule 404c-1 in 1987. Proposed Regulation Regarding Participant Directed Individual Account Plans (ERISA Section 404(c) Plans), 52 FR (continued..)

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Plan fiduciaries would be relieved of their fiduciary obligations for choosing plan investments where participants are provided with an opportunity to exercise control over the assets in their individual accounts and given an opportunity to choose from a broad range of investments, including at least three diversified categories of investments. While the proposed regulations would require that sufficient information be available from public sources for the three investment options, they would not require the plan fiduciary actually to *furnish* adequate written information about designated alternatives to those participants who request it.<sup>105</sup> Further, the sufficient information requirement would not apply to any investment options over and above the required three.

Under **ERISA**, a participant, fiduciary, or the Secretary of Labor may bring a civil action to enforce any provision of **ERISA**, including the right to receive a Summary Plan Description.<sup>106</sup> Participants and fiduciaries may also bring civil actions for violations of the terms of the plan. Further, the Secretary of Labor may levy fines against a plan administrator who fails to comply with a participant's request for information required under **ERISA**'s reporting and disclosure requirements in a timely manner, where **ERISA** requires that such information be provided to the participant upon request.

The Comptroller's rules for bank collective funds require banks to make available upon request a written plan, approved by the bank's board of directors, that generally describes the policies of the bank with respect to the fund, the allocation of income, profits and losses, and the terms for admission and withdrawal.<sup>107</sup> The bank must make available upon request an audited annual financial report that includes a list of the fund's investments, income and disbursements, and fees charged by the bank to the fund. That financial report may, but need not, include a description of the fund's value on previous dates, as well as its income and disbursements during previous periods.<sup>108</sup> The

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<sup>104</sup>(...continued)

33508 (1987) (proposing 29 C.F.R. § 2550.404c-1). The 1987 proposal elicited a number of comments and a public hearing was held to address certain controversial aspects of the rule. After considering the comments and testimony, the Department of Labor substantially revised the 1987 proposal and repropose rule 404c-1 in 1991. Participant Directed Individual Account Plans, 56 FR 10724 (reproposing 29 C.F.R. § 2550.404~1).

<sup>105</sup>If the investment options are limited to investments designated by the plan, the plan must make available an identified plan fiduciary to direct employees to sources of information. *Id.* at 10728, 10737 (proposed 29 C.F.R. § 2550.404c-1(b)(3)(iii)).

<sup>106</sup>29 U.S.C. § 1132(a)(3), (5).

<sup>107</sup>12 C.F.R. § 9.18(b)(1).

<sup>108</sup>12 C.F.R. § 9.18(b)(5).

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Comptroller of the Currency has general authority to fine any national bank or affiliated party for violations of any provision of the laws or regulations governing national banks, including failure to provide these materials, but investors have no private right of action?''

## **2. Shareholder and Periodic Reports**

### **a. Shareholder Reports**

An investment company must provide reports to shareholders of record at least semi-annually.'' The semi-annual report must contain the fund's balance sheet; an income statement; a portfolio schedule that shows the amount and value of each security owned by the fund on that date; a statement of operations (net changes); and condensed financial information (the per share table)?'' The annual report must include audited financial statements accompanied by a certificate of an independent public accountant.<sup>112</sup>

The Exchange Act also requires investment companies to provide reports to shareholders. Any proxy solicitation with respect to an annual meeting for the election of directors must be preceded or accompanied by an annual report to shareholders.<sup>113</sup> A bank or other fiduciary who holds securities in nominee name is generally required to pass through all proxy materials, including shareholder reports, to the beneficial owners on whose behalf it holds the securities.<sup>114</sup>

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<sup>109</sup>See 12 U.S.C. § 93(b). The statute provides a formula for determining the amount of any fine. Id.

<sup>110</sup>15 U.S.C. § 29(d); 17 C.F.R. § 270.30d-1.

<sup>111</sup>The per share table in an annual report must contain financial information for five years. The per share table in a semi-annual report must contain financial information for the period covered by the report and the preceding fiscal year. Item 23, Instruction 5(ii) to Form N-1A, Investment Company Act Release No. 13436 (Aug. 12, 1983), 48 FR 37928.

<sup>112</sup>15 U.S.C. § 80a-29(d), (e); 17 C.F.R. § 270.30d-1.

<sup>113</sup>17 C.F.R. § 240.14a-3(b).

<sup>114</sup>17 C.F.R. § 240.14b-2. Participants in an employee benefit plan are considered to be the beneficial owners entitled to receive proxy materials if they have the right under the plan or otherwise to vote the securities held on their behalf. See Shareholder Communications Facilitation, Securities Exchange Act Release No. 23847 (Nov. 25, 1986), 51 FR 44267. Employee benefit plans sponsored by the issuer or an affiliate of the issuer must comply with different procedures regarding the delivery of shareholder reports and proxy materials. See Facilitation of Shareholder Communications, Securities Exchange Act Release No. 25631 (Apr. 27, 1988), 53 FR 16399 (continued...)

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ERISA requires that participants receive a Summary Annual Report that discloses the net change in the value of the plan's assets, net unrealized appreciation of plan assets, total expenses, and total income.<sup>115</sup> The Summary Annual Report is not required to include information about a plan's investments.<sup>116</sup> The Summary Annual Report is a condensed version of the detailed annual report that must be filed on Form 5500 with the IRS, which must include, among other things, audited financial statements and information about the plan's investments.<sup>117</sup> ERISA does not require the participant to be given the plan's Form 5500. Consequently, a participant will have to request a copy of Form 5500 from the plan administrator if it wants financial information about the plan's investments.<sup>118</sup> If a plan invests in a bank collective trust fund or an insurance company separate account, plan participants who request a copy of the plan's Form 5500 will also receive a copy of the annual statement of assets and liabilities of the collective trust fund or separate account.<sup>119</sup> ERISA regulations do not require independently-audited financial statements as to plan assets held in a collective trust fund or a separate account if the statements are prepared by a bank or insurance company regulated, supervised, and subject to examination by a state or federal agency and such statements are certified by the bank or insurance company and made part of the annual report.<sup>120</sup>

In addition to its filing obligations under ERISA, a national bank that administers a collective trust fund is required by the Comptroller's rules to

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<sup>114</sup>(...continued)

(adopting rules excluding some employee benefit plan participants from proxy processing and direct communications provisions).

<sup>115</sup>29 U.S.C. § 1024(b)(3); 29 C.F.R. § 2520.104b-10.

<sup>116</sup>Form for Summary Annual Report Relating to Pension Plans, 29 C.F.R. § 2520.104b-10(d)(3).

<sup>117</sup>A plan does not file its Form 5500 annual report directly with the Department of Labor. Plans sponsored by smaller employers may file a simplified annual report on Form 5500-C or Form 5500-R with the IRS, without audited financial statements.

<sup>118</sup>See 29 C.F.R. § 2520.104b-10(d)(3).

<sup>119</sup>ERISA requires banks and insurance companies to provide sufficient information to plan sponsors to allow them to complete Form 5500, including a copy of the statement of assets and liabilities of any collective trust fund or separate account in which the plan invests. 29 U.S.C. § 1023(a)(1)(B)(2). ERISA also requires plans to file with its Form 5500 an annual statement of assets and liabilities for any collective trust fund or separate account in which it invests. 29 U.S.C. § 1023(b)(3)(G). Alternatively, the bank or insurance company may file the statement directly with the Department of Labor and provide a copy to the plan administrator, in which case the plan's Form 5500 incorporates the statement by reference. 29 U.S.C. § 1023(b)(4); 29 C.F.R. § 2520.103-9.

<sup>120</sup>29 U.S.C. § 1023(a)(3)(C); 29 C.F.R. § 2520.103-8.

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prepare an audited financial report of the fund at least once a year.<sup>121</sup> The financial report must include a list of the fund's investments, income and disbursements, and fees charged by the bank to the fund. Unlike an investment company's obligation to *deliver* financial information to shareholders and similar to ERISA's requirement that financial information about the plan *be made available upon request to plan participants*, banking regulations only require a national bank to *provide notice of the availability* of the annual financial report to any *plan* invested in its collective trust fund.<sup>122</sup> While a bank must furnish a plan with a copy of the financial report upon request, there is no specific requirement under the banking regulations that the bank furnish annual financial reports to *plan participants*.

### **b. Periodic Reports**

Investment companies must annually and semi-annually report to the Commission on Form N-SAR.<sup>123</sup> The annual report must include financial information and an annual report by the independent accountant on the material weaknesses in internal accounting controls noted during its audit.<sup>124</sup>

Employee benefit plans are required to file an annual report with the IRS on Form 5500, including audited financial statements, as described above.<sup>125</sup>

Bank collective trust funds are not required to file periodic reports with the Comptroller.<sup>126</sup> The auditor of a collective fund's annual financial report, described above, is not required to file any report pointing out weaknesses in a fund's internal accounting controls found during its audit.

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<sup>121</sup>12 C.F.R. § 9.18(5)(ii).

<sup>122</sup>12 C.F.R. § 9.18(b)(5)(iv).

<sup>123</sup>15 U.S.C. § 80a-29(a); 17 C.F.R. §§ 270.30a-1, 270.30b1-1.

<sup>124</sup>See Item 77B and accompanying instructions to Form N-SAR, Investment Company Act Release No. 14299 (Jan. 4, 1985), 50 FR 1442; AUDIT AND ACCOUNTING GUIDE, Audits of Investment Companies 164 (Am. Inst. of Certified Pub. Accountants 1987).

<sup>125</sup>See *supra* notes 117,118,119,120 and accompanying text.

<sup>126</sup>See 12 C.F.R. § 9.18(b)(5).

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## B. Recommendations for Reform

Today, plan participants receive far less information about the investment objectives and policies, performance, investment managers, fees, and expenses of their investment options than do investors who directly purchase securities issued by investment companies or other issuers. The Division believes that disclosure to plan participants who direct and bear the risk of their investments should be improved. Therefore, we recommend that the Commission send to Congress legislation that would remove the current exemption from Securities Act registration in section 3(a)(2) for interests in pooled investment vehicles consisting of assets of participant-directed defined contribution plans. Further, we recommend that the legislation amend the federal securities laws to require the delivery of prospectuses for the underlying investment vehicles to plan participants who direct their investments. We also recommend legislation that would amend the Exchange Act to require the delivery of semiannual and annual shareholder reports for the underlying investment vehicles (other than registered investment companies) to these plan participants. Finally, we recommend that the rules under the Investment Company Act be amended to require the delivery of semiannual and annual reports of underlying registered investment companies to these plan participants.

Two factors prompted us to reconsider the Securities Act exemption for interests in pooled investment vehicles for participant-directed defined contribution plans. The historical reasons justifying the securities law exemptions of pooled vehicles for employee benefit plan assets -- that "sales" are made to sophisticated employers and that the employers bear the risk of loss -- are both inapposite in the case of participant-directed defined contribution plans. Second, the current ERISA requirements and banking regulations do not provide investors with information comparable to that provided under the securities laws. Although plan fiduciaries are held to a "prudent person" standard under ERISA with respect to the initial and continued suitability of the investment alternatives designated by the plan sponsor in a participant-directed plan, participants nonetheless must make the final investment decision in such plans.<sup>127</sup> Participants in these plans are in a position similar to that of an ordinary investor, but *without* the benefits of the disclosure provided under the federal securities laws.

Accordingly, we recommend that the Commission seek legislation to amend section 3(a)(2) of the Securities Act to remove the exemption from registration for interests issued by those collective trust funds and separate accounts in which participant-directed defined contribution plan assets are

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<sup>127</sup>See *infra* notes 133-137 and accompanying text (ERISA prudence requirements).

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invested.<sup>128</sup> We only recommend removal of the exemption from registration for interests in pooled investment vehicles, not the exemption for the participant's interest in the plan itself. We further recommend that the securities laws be amended to require the delivery of prospectuses of underlying collective trust funds, separate accounts, and registered investment companies to the participants in these participant-directed plans. These recommendations would provide plan participants who make their own investment decisions with the benefit of the disclosures required under the federal securities laws. As we have discussed above, these disclosures are far more timely and comprehensive than those currently required under ERISA or the banking regulations. Moreover, those making these disclosures would be subject, for the first time, to civil liability for material misstatements and omissions under sections 11 and 12(2) of the Securities Act.<sup>129</sup> These pooled investment vehicles, however, otherwise would remain subject to ERISA, the Internal Revenue Code, and, with respect to bank collective trust funds, the Comptroller's regulations.

Subsequent to their initial decision to invest in securities, participants have a continuing need for information to evaluate their investments and decide whether to maintain or reallocate them. Essential information for this ongoing investment review is contained in the issuers' current prospectuses and shareholder reports. For this reason, the Division believes that the federal securities laws should be amended to require delivery of prospectuses of underlying collective trust funds, separate accounts, and registered investment companies to plan participants when they reallocate their investments. In addition, to ensure that participants receive important financial information in connection with monitoring their investments, the Division recommends that the periodic reporting exemption in the Exchange Act for collective trust funds and separate accounts be deleted and that those pooled investment vehicles be required to transmit to participants the same information required of investment companies under the shareholder reporting provision of the Investment Company

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<sup>128</sup>We conclude that it is appropriate to continue the securities law exemptions for pooled investment vehicles, and interests therein, that consist exclusively of assets of defined benefit plans and defined contribution plans that do not provide for participant direction. ERISA imposes duties and liabilities on sponsors and managers of these plans that relieve the individual participant of much of the responsibility for the management of his or her assets under the plan. With respect to defined benefit plans in particular, the employers bear the investment risks, and the plans are subject to certain ERISA funding and liability requirements that are not applicable to defined contribution plans. Unlike defined contribution plans, defined benefit plans generally are insured by the PBGC.

<sup>129</sup>We believe that both a plan, and its participants on a derivative basis, should have a cause of action against issuers who violate these sections – in the same way as any other issuer is liable. The plan sponsor or fiduciaries should be liable for an issuer's material misstatement or omission only if it reasonably should have known about it.

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Finally, the rules under the Investment Company should be amended to ensure that all beneficial owners in registered investment companies receive semiannual and annual reports.

## V. Substantive Regulation of Pooled Investment Vehicles

We also considered whether section 3(c)(11) of the Investment Company Act should be amended to require collective funds and separate accounts to register as investment companies. To analyze this issue, we compared the three regulatory frameworks. This section compares certain key areas of substantive regulation under the Investment Company Act, **ERISA**, and the Comptroller's regulation 9. We conclude that while the protections provided by the Investment Company Act probably are somewhat greater, **ERISA** adequately protects participants in both defined benefit and defined contribution plans, including participant-directed defined contribution plans. Requiring these pooled investment vehicles to register under the Investment Company Act would be costly and disruptive. Accordingly, we do not recommend that these collective trust funds and separate accounts be required to register under the Investment Company Act.

The three regulatory frameworks impose differing sets of requirements and apply to groups of persons with differing relationships to employee benefit plan assets. Despite those differences, in many key areas of investor protection investment companies, bank collective funds, and insurance company separate accounts holding plan assets are subject to comparable (though not identical) regulation.

### A. Fiduciary Standards

The Investment Company Act imposes several somewhat general fiduciary duties on certain persons in connection with their investment company activities. **An** investment company's investment adviser has a fiduciary duty with respect to any compensation, including its management fee, it receives from an investment company or its shareholders, Section 36(b) allows the Commission or any shareholder to bring an action for breach of this fiduciary duty.<sup>131</sup> Section 36(a) authorizes the Commission to bring an action for injunctive or other judicial relief against any officer, director, investment adviser, or principal underwriter of an investment company for breach of fiduciary duty involving personal

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<sup>130</sup>As further discussed *supra* at notes 110-112 and accompanying text, the Investment Company Act shareholder reporting provisions, section 30(d) and rule 30d-1 thereunder, require a registered investment company to provide semi-annual and annual reports containing basic financial information about the fund. See 15 U.S.C. § 80a-29(d); 17 C.F.R. § 270.30d-1.

<sup>131</sup>15 U.S.C. § 80a-35(b).

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**misconduct.**<sup>132</sup> Further, the antifraud provision of the Investment Advisers Act of 1940 also protects investment companies and their shareholders against fraudulent, deceptive, and manipulative conduct by investment advisers.<sup>133</sup>

ERISA contains an explicit fiduciary requirement that obligates an ERISA plan fiduciary to act "with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man [sic] acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims."<sup>134</sup> The plan fiduciary must ensure that the plan's investments are diversified to minimize the risk of large losses, unless it is clearly prudent not to do so,<sup>135</sup> and generally act in accordance with the plan documents.<sup>136</sup> A plan fiduciary must monitor the performance and suitability of plan investments.<sup>137</sup> A plan fiduciary also may be liable for another fiduciary's breach of fiduciary duty under certain circumstances.<sup>138</sup>

ERISA preempts state civil law with respect to employee benefit plans.<sup>139</sup> Participants, therefore, cannot bring a common law action for breach of fiduciary duty against a plan fiduciary. Participants, beneficiaries, fiduciaries, and the Secretary of Labor may bring civil actions under ERISA for any breach of fiduciary duty, including breaches of the prohibited transactions provisions.<sup>140</sup>

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<sup>132</sup>15 U.S.C. § 80a-35(a).

<sup>133</sup>15 U.S.C. § 80b-6.

<sup>134</sup>29 U.S.C. § 1104(a)(1)(B).

<sup>135</sup>29 U.S.C. § 1104(a)(1)(C).

<sup>136</sup>Generally, a fiduciary must consider certain factors in the prudent performance of its investment duties, including the diversification of the plan's assets, liquidity and current return, and projected return. 29 C.F.R. § 2550.404a-1.

<sup>137</sup>ERISA does not set forth specific requirements with respect to the type of information that pooled investment vehicles must provide to the plan sponsors.

<sup>138</sup>29 U.S.C. § 1105(a).

<sup>139</sup>29 U.S.C. § 1144(a).

<sup>140</sup>29 U.S.C. §§ 1132(a)(2)-1132(a)(3). See generally Daniel Candee Knickerbocker, *Trust Law with a Difference: An Overview of ERISA Fiduciary Responsibility*, 23 REAL PROP. PROB. & TR. J. 633 (1988) (comparing fiduciary duties and liabilities under ERISA and traditional trust law). Recently, the Department of Labor filed suits against employers and other fiduciaries, charging them with violating their fiduciary responsibility in purchasing retirement annuities for their employees from a subsidiary of bankrupt First Executive Corp. See U.S. is Suing AFG on Buying Annuities From Executive Life, WALL ST. J., July 12, 1991, at C8; Robert Rosenblatt, U.S. Challenges Pension Switching, (continued..)

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The Secretary is required to assess a civil penalty against a fiduciary for breaching a fiduciary duty or engaging in a prohibited transaction and may also assess a civil penalty against a party in interest for violations of the prohibited transactions provisions.<sup>141</sup> The Internal Revenue Code also imposes excise taxes on "disqualified persons" who engage in prohibited transactions with a plan.<sup>142</sup>

ERISA imposes strict responsibilities and limitations on banks and insurance companies as fiduciaries with respect to plans whose assets are invested in collective funds or separate accounts. ERISA defines as a plan fiduciary any person who exercises discretion with respect to the management of a plan or its assets, renders investment advice to a plan for a fee (direct or indirect), or has discretion with respect to the administration of a plan.<sup>143</sup> This generally includes the plan sponsor, its directors, and certain of its officers and employees. A fiduciary must act with respect to the plan solely in the interest of the plan participants and for the exclusive purpose of (i) providing benefits to the participants and (ii) defraying reasonable expenses of administering the plan.<sup>144</sup>

ERISA limits a plan fiduciary's fiduciary responsibility to the specific plan assets over which it exercises discretion or has the responsibility that makes it a fiduciary.<sup>145</sup> When a plan invests in an entity, the "plan assets" of the plan generally include its investment but not, solely by reason of that investment, any

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<sup>140</sup>(...continued)

L.A. TIMES June 13, 1991, at A1; Frank Swoboda, *U.S. Tests Rules on Annuities Purchased by Pension Funds*, WASH. POST, June 13, 1991, at B11; see also Ann Hagedorn & Suein L. Hwang, *Unisys Sued for Investing in Executive Life*, WALL ST. J., June 17, 1991, at B3 (suit brought by plan participants alleging imprudent investments).

<sup>141</sup>29 U.S.C. §§ 1132(i), 1132(l).

<sup>142</sup>The Internal Revenue Code contains a similar set of prohibited transactions provisions and statutory exemptions with respect to plans qualified under section 401. Most of the transactions prohibited under ERISA give rise to excise taxes under the Code. However, the Code imposes the excise taxes on a smaller class of persons. Compare 26 U.S.C. § 4975(c) (prohibited transactions) with 29 U.S.C. § 1106 (prohibited transactions).

<sup>143</sup>29 U.S.C. § 1002(21)(A). See also 29 C.F.R. § 2510.3-21(c)(1) (definition of "investment advice").

<sup>144</sup>29 U.S.C. § 1104(a).

<sup>145</sup>Exemptions From Prohibitions Respecting Certain Classes of Transactions Involving Employee Benefit Plans and Certain Broker-Dealers, Reporting Dealers, and Banks, Prohibited Transaction Exemption 75-1, 40 FR 50845, 50846 (1975) [hereinafter PTE 75-1]. See 29 C.F.R. § 2510.3-21 (definition of "fiduciary"). A person is a fiduciary only with respect to those plan assets over which that person exercises any fiduciary responsibility. That person, however, is a party in interest with respect to all plan assets. PTE 75-1, *supra*, at 50846. For a discussion of "party in interest," see *infra* note 155 and accompanying text.

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of the underlying assets of that entity.<sup>146</sup> When a plan invests in an equity interest of a company that is not an operating company and the security is neither a publicly-offered security nor a security issued by a registered investment company, however, the plan's assets include both the equity interest and an undivided interest in the underlying assets of the entity that issued the equity interest.<sup>147</sup> **ERISA** makes any person exercising authority or control over the management or disposition of the underlying assets of that entity, and any person who provides investment advice with respect to those assets for a fee (direct or indirect), a fiduciary of the **investing plan**, subject to all of the duties and liabilities imposed upon plan **fiduciaries**.<sup>148</sup> When a plan invests in a collective trust fund or a pooled separate account, plan assets include both the interest issued by the entity and an undivided interest in each of the underlying assets of the entity.<sup>149</sup> Consequently, any person who exercises authority or control respecting the management or disposition of the underlying assets of the collective trust fund or separate account, and anyone providing investment advice with respect to such assets for a fee (direct or indirect), is a fiduciary of the plan. These persons could include a bank's or insurance company's board of directors or investment committee, or a bank's trust department.

Regulation 9 describes national banks as fiduciaries with respect to the employee benefit plan assets they invest in their collective trust funds but, unlike the Investment Company Act and **ERISA**, does not enumerate specific fiduciary duties. Regulation 9 does not provide specific remedies for breach of fiduciary duty with respect to investments in collective trust funds. Nonetheless, the Comptroller of the Currency may fine a national bank or an affiliated party for

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<sup>146</sup>29 C.F.R. § 2510.3-101(a)(2).

<sup>147</sup>*Id.* If equity participation in the entity by benefit plan investors is not significant, plan assets include only the equity interest in the entity. *Id.*

<sup>148</sup>*Id.*

<sup>149</sup>29 C.F.R. § 2510.3-101(h)(1). The underlying assets of separate accounts maintained solely in connection with guaranteed investment contracts under which amounts payable to the plan are not affected in any manner by the investment performance of the separate account are not plan assets.

By contrast, when a plan invests in securities issued by an investment company, those securities -- but not any assets of the investment company -- become plan assets. 29 U.S.C. § 1101(b)(1). Accordingly, neither the investment company nor its investment adviser or principal underwriter is treated as a fiduciary of such plan under ERISA. 29 U.S.C. § 1002(21)(B). This special treatment of investment companies reflects Congress' perception that the Investment Company Act already subjects investment companies to extensive fiduciary regulation. See William M. Tarkoff, *Treatment of Mutual Funds Under ERISA*, 1979 DUKE LJ. 577, 581 (citing pertinent legislative history).

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violating the banking laws or regulations constituting a breach of fiduciary duty.<sup>150</sup>

## B. Prohibitions Against Self-Dealing: Investment Company Act, ERISA, and Regulation 9

The Investment Company Act extensively restricts self-dealing between investment companies and their affiliates. As discussed in detail in Chapter 12, section 17 restricts three broad categories of affiliated transactions to protect investors from a variety of conflicts of interest that may arise when a passive pool of assets is within the reach of interested parties. The Investment Company Act prohibits or restricts transactions in which an affiliate (or an affiliate of an affiliate): (1) purchases securities from or sells securities to, or borrows money or property from, the investment company ("principal transactions"); (2) jointly participates in a transaction with the registered investment company ("joint transactions"); and (3) acts as broker or agent for the investment company ("agency transactions").<sup>151</sup> Further, to prevent an affiliate from unloading or "dumping" unwanted securities into an investment company, section 10(f) of the Investment Company Act generally prohibits an investment company from purchasing securities in an underwriting in which any affiliated person participates as a principal underwriter.<sup>152</sup> Under rule 10f-3, investment companies may purchase securities from a syndicate containing an affiliate if certain safeguards are met.<sup>153</sup>

To protect a plan's assets against abusive practices by persons in a position to control those assets, ERISA prohibits plans from engaging in transactions with two types of persons: "parties in interest" and "fiduciaries." "Party in interest" is defined broadly to include many persons who, by virtue of a financial interest in a plan's operations, or some relationship to a plan or another party in interest, might be in a position to exert improper influence over the plan to the detriment of the plan and its participants.<sup>154</sup> Plan investment managers, administrators, and other fiduciaries are parties in interest and thus subject to the prohibitions

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<sup>150</sup>12 U.S.C. § 93(b).

<sup>151</sup>15 U.S.C. § 80a-17.

<sup>152</sup>15 U.S.C. § 80a-10(f).

<sup>153</sup>17 C.F.R. § 270.10f-3.

<sup>154</sup>See 29 U.S.C. § 1002(14)(A) (definition of "party in interest"). Parties in interest with respect to a particular plan include the sponsors, fiduciaries, and service providers of the plan and all officers, directors, employees, and ten percent shareholders of the plan sponsor and the plan. 29 U.S.C. § 1002(14)(A)-(I).

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applicable to all parties in interest as well as certain prohibitions specifically governing only fiduciaries.

The coverage of ERISA's self-dealing and conflict of interest prohibitions is similar but not identical to those of the Investment Company Act. These differences exist partly because the Investment Company Act self-dealing prohibitions affect transactions between the investment company and any "affiliated person," a defined term broader in some respects and narrower in others than "party in interest."<sup>155</sup> For example, the owner of five percent of the outstanding voting shares of an investment adviser must comply with the Investment Company Act self-dealing restrictions, whereas only a ten percent or larger shareholder **of** a plan sponsor would be subject to ERISA's *per se* prohibited transactions provisions. On the other hand, any custodian of a plan and any person who provides services to a plan, such as a broker, is a party in interest with respect to that plan, while a person who provides custodial or brokerage services to an investment company is not, for that reason alone, an affiliated person of the investment company. Differences in coverage also exist because the Investment Company Act does not distinguish between fiduciaries and other affiliated persons with respect to its self-dealing prohibitions, while some of ERISA's prohibitions apply only to "fiduciaries," a defined term covering plan trustees, investment advisers, and administrators.<sup>156</sup>

ERISA's core prohibitions, contained in section 406, are generally comparable to many of those in the Investment Company Act. Under section 406(a), a plan may not engage in a transaction with a party in interest that would directly or indirectly constitute: a sale, exchange, or lease of any property; a loan of money or other extension of credit; furnishing goods, services, or facilities; a transfer to or use by or for the benefit of a party in interest of any assets of the plan; or an acquisition on behalf **of** the plan of employer securities or employer real property in excess of prescribed limits which, for defined benefit plans, would be 10% of plan assets.<sup>157</sup> As with the Investment Company Act, ERISA permits affiliates to provide certain services to the fiduciary client. Section 406(b) prohibits a plan fiduciary from dealing with plan assets for its own interest or account, acting on behalf of any party whose interests are adverse to the plan's or participants' interests in a transaction involving the plan, or receiving any consideration (*i.e.*, kickbacks) from any party dealing with the plan in connection with a transaction involving assets of the plan.

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<sup>155</sup>Compare 15 U.S.C. § 80a-2(a)(3) with 29 U.S.C. § 1002(14) (definitions of "affiliated person" and "party in interest").

<sup>156</sup>See 29 U.S.C. §§ 1002(21)(A), 1106(b).

<sup>157</sup>See 29 U.S.C. § 1106(a)(1).

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Regulation 9 subjects bank collective funds to some self-dealing restrictions. A national bank maintaining a collective trust fund may not sell to or purchase from the collective trust fund securities or other property, although affiliates of the bank are not prohibited from making such purchases or sales.<sup>158</sup> Banks may purchase securities on behalf of their collective trust funds in an underwriting in which an affiliate participates, if a majority of the bank's outside directors approves the transaction.<sup>159</sup> Even if a bank fails to obtain approval of the outside directors, it may "cure" a self-dealing underwriting transaction through disclosure.<sup>160</sup>

## 1. Principal Transactions: Prohibitions and Exceptions

Section 17(a) of the Investment Company Act prohibits an affiliate of an investment company, acting as principal, from knowingly purchasing or selling securities or property from or to the investment company. It also prohibits affiliates from borrowing from the investment company. The Commission has adopted rules providing certain exceptions from these prohibitions.<sup>161</sup> In addition, under section 17(b), the Commission may exempt a proposed transaction if its terms are fair and reasonable, involve no overreaching by any person, and are consistent with the general purposes of the Investment Company Act.

Notwithstanding the prohibitions of section 17(a), section 17(c) permits an affiliated person, in the ordinary course of business, to purchase from or sell to an investment company merchandise, enter into lessor-lessee relationships with the investment company, and furnish services incident thereto. Nevertheless, the Investment Company Act and the rules thereunder protect against affiliated persons engaging in self-dealing with respect to service contracts with investment companies. As earlier noted, an investment adviser and its affiliated persons have a fiduciary duty with respect to any compensation, including any fees for services it receives from an investment company or its shareholders. Under section 36(b) of the Investment Company Act, both the Commission and shareholder may sue

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<sup>158</sup>12 C.F.R. § 9.18(b)(8)(i).

<sup>159</sup>The Competitive Equality Banking Act of 1987, Pub. L. No. 100-86, § 102(a), 101 Stat. 552, 564 (1987) (codified at 12 U.S.C. § 371c-1), added Section 23B to the Federal Reserve Act, which prohibits the purchase of securities by a member bank or its subsidiary, either as principal or fiduciary, from any underwriting in which an affiliate is a "principal underwriter" of those securities, unless a majority of the outside directors of the bank approves the purchase.

<sup>160</sup>OFFICE OF THE COMPTROLLER OF THE CURRENCY, Trust Banking Circular No. 19 (Sept. 25, 1981), 5 Fed. Banking L. Rep. (CCH) ¶ 59,309.

<sup>161</sup>See Chapter 12.

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the adviser for breach of this fiduciary duty.<sup>162</sup> Shareholders know exactly what they pay to affiliates for services, because all expenses incurred by an investment company, including those paid to affiliates for services, must be reflected on the fee table in the fund's **prospectus**.<sup>163</sup> Finally, an affiliated person may perform services for an investment company without violating section 17(d)<sup>164</sup> only if adequate safeguards exist, including approval by the investment company's directors, to prevent overreaching.<sup>165</sup>

Because of the large number of persons subject to ERISA's self-dealing prohibitions, **ERISA** contains several exemptions from the prohibited transactions provisions of section 406(a).<sup>166</sup> Further, the Department of Labor has issued a number of class exemptions to permit potentially beneficial principal transactions where it perceives self-dealing opportunities as minimal.<sup>167</sup> For example, a separate account or a bank collective trust fund may engage in otherwise prohibited transactions with a party in interest, or acquire or hold employer securities or real property, provided the assets of the plan invested in that separate account or collective trust fund do not exceed ten percent of the total assets of the separate account or collective trust fund.<sup>168</sup>

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<sup>162</sup>15 U.S.C. 80a-35(b).

<sup>163</sup>Item 2 of Form N-1A, Investment Company Act Release No. 16244 (Feb. 1, 1988), 53 FR 3192.

<sup>164</sup>Discussed **infra** at notes 199-201 and accompanying text.

<sup>165</sup>See, e.g., Merrill Lynch Capital Fund, Inc. (pub. avail. Dec. 21, 1990); Washington Square Cash Fund (pub. avail. July 9, 1990); Unified Management Corporation (pub. avail. June 28, 1990); The Flex-fund (pub. avail. Nov. 22, 1985); Federated Securities Corp. (pub. avail. Oct. 21, 1983).

<sup>166</sup>See 29 U.S.C. § 1108. These statutory exemptions do not relieve fiduciaries from the general standards of prudence and loyalty that govern a fiduciary's obligations with respect to a plan.

<sup>167</sup>Class exemptions may provide relief from some or all of the section 406(a) prohibited transactions provisions, or some or all of the section 406(b) fiduciary self-dealing restrictions, or both.

<sup>168</sup>Amendment to Prohibited Transaction Exemption (PTE) 80-51 Involving Bank Collective Investment Funds, Prohibited Transaction Exemption 91-38, 56 FR 31966, 31969 (1991) [hereinafter PTE 91-38]; Amendment to Prohibited Transaction Exemption (PTE) 78-19 Involving Insurance Company Pooled Separate Accounts, Prohibited Transactions Exemption 90-1/55 FR 2891 (1990) [hereinafter PTE 90-1]. These exemptions do not relieve a fiduciary from liability for self-dealing under section 406(b). Indirect holdings in qualifying employer securities and qualifying employer real property are not counted for purposes of this 10% limitation. PTE 91-38, *supra*, at 31969; PTE 90-1, *supra*, at 2893. Further, the party in interest engaging in the transaction may not be the insurance company or bank, any separate account of that insurance company or collective investment fund of that bank, or any affiliate of either.

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All transactions between a separate account or collective trust fund and a person who is a party in interest solely by reason of providing services to the plan (including a plan fiduciary), or having a particular relationship to a service provider, are also **exempt**.<sup>169</sup> Another exemption conditionally permits any purchase or sale of a security between a plan and a registered broker-dealer, a primary dealer in U.S. government securities, a bank, or any affiliate of such persons, that is not a fiduciary and is a party in interest *solely* by virtue of providing services to the plan.<sup>170</sup>

A party in interest of a plan may engage in otherwise prohibited transactions involving plan assets (including a collective trust fund or separate account in which the plan invests) if the assets are managed by a "qualified professional asset manager" ("QPAM").<sup>171</sup> A QPAM must be a bank, savings and loan, insurance company, or registered investment adviser and must meet certain equity capital or net worth standards. To qualify as a QPAM with respect to a transaction, the plan's assets, together with the assets of any other plan maintained by the same employer, or an affiliate thereof, or employee organization must not constitute more than twenty percent of the total client assets managed by that QPAM at the time of the transaction. The QPAM also must be independent of the parties in interest involved in any transaction covered by this class **exemption**.<sup>172</sup>

A plan's sale or purchase of an interest in a collective trust fund or a separate account of an insurance company is also exempt from the prohibited

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<sup>169</sup>PTE 91-38,*supra* note 168, at 31968; PTE 90-1,*supra* note 168, at 2893. Unlike the previous exemption, a fiduciary would not be liable for self-dealing under this exemption. See *supra* note 169 and accompanying text. However, the party in interest must not be affiliated with the insurance company or bank and must not have any discretion with respect to the plan's investment in the separate account or collective investment fund or the management or disposition of the assets of the separate account or collective investment fund.

<sup>170</sup>PTE 75-1,*supra* note 145, at 50847.

"Class Exemption for Plan Asset Transaction Determined by Independent Qualified Professional Asset Managers, Prohibited Transaction Exemption 84-14/49FR 9494 (1984), amended 50 FR 41430 (1985). A QPAM must have investment discretion over the plan assets, but need not have custody. *Id.* at 9506. Transactions involving fiduciary self-dealing or the acquisition of employer securities or real property are not covered by this exemption.

<sup>172</sup>A transaction will not be exempt under this class exemption if the party in interest, or an affiliate thereof, has the power, or within the preceding 12 months has exercised the power, to appoint or remove the QPAM or to negotiate the terms of the management agreement with the QPAM. *Id.* at 9504. Further, the party in interest dealing with the investment fund must not be the QPAM or any person that owns a 5% interest in, or is 5% owned by, the QPAM. *Id.* at 9504, 9506.

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transactions provisions under certain conditions.<sup>173</sup> The plan must pay no more than reasonable compensation in connection with the transaction. The purchase or sale must be expressly permitted by the instrument governing the plan or by a fiduciary (other than the bank, trust company, insurance company, or an affiliate thereof) that has authority to manage and control the assets of the plan. The exemption relieves parties in interest from the prohibited transactions provisions of section 406(a) of ERISA. The Department of Labor has not stated whether the exemption also relieves fiduciaries from the self-dealing or conflicts of interest prohibitions of Section 406(b), although the Department has stated that a bank that is a fiduciary of a plan would not violate Section 406(b) if the bank invested the assets of the plan in its "common trust fund" where the bank had no discretion with respect to that investment.<sup>174</sup> It is not clear whether this exemption might allow a plan to invest in a collective trust fund or separate account with the expectation that the bank or insurance company will then extend a loan to, or engage in other transactions for the benefit of, a party in interest.<sup>175</sup> The Department of Labor has said, however, that a plan's purchase of an insurance policy pursuant to an arrangement under which the insurance company will then lend money to a party in interest would be a prohibited transaction:<sup>76</sup>

The Department of Labor also has exempted the purchase or sale of a security between a plan and a fiduciary that is a market-maker for that security, subject to certain conditions, as long as there is at least one other market-maker for the security, and the net price for the transaction is more favorable to the plan than that which the fiduciary, acting in good faith, reasonably believes to be

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<sup>173</sup>29 U.S.C. § 1108(b)(8).

<sup>174</sup>Opinion 88-11A, 1988 ERISA LEXIS 11 (Aug. 17, 1988). See also Proposed Class Exemption for Certain Transactions Involving Bank Collective Investment Funds, 44 FR 44290, 44291 n.3 (1979) (proposing PTE 80-51, predecessor to current PTE 91-38, *supra* note 168).

<sup>175</sup>If the loan to a non-fiduciary party in interest is from the collective trust fund or separate account (*i.e.*, the loan is from plan assets), the transaction, while prohibited, would fall within two class exemptions which exempt transactions between a pooled investment vehicle and a party in interest of a plan where the plan's assets constitute no more ~~than~~ 10% of the assets of the collective trust fund or separate account. See PTE 91-38, *supra* note 168, at 31966; PTE 90-1, *supra* note 168, at 2891. However, if the bank loans funds that are not plan assets to a non-fiduciary party in interest, it might not be a prohibited transaction, even if the plan has a substantial investment in the bank's collective trust fund. A loan to a **fiduciary** under these circumstances might be self-dealing under section 406(b).

<sup>176</sup>Interpretive Bulletin Relating to Prohibited Transactions, 29 C.F.R. § 2509.75-2.

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available at the time from all other market-makers.<sup>177</sup> However, the Department stated that such a transaction might be deemed a prohibited transaction if its purpose was to benefit the fiduciary or an affiliate of such fiduciary.<sup>178</sup> Plan assets may be invested in short term debt instruments issued by a party in interest such as bankers' acceptances, commercial paper, repurchase agreements, and certificates of deposit issued by parties in interest.<sup>179</sup> A registered broker-dealer that executes securities transactions for a plan and hence is a party in interest, but is not a fiduciary, may extend credit to a plan in connection with the purchase or sale of securities.<sup>180</sup> Conversely, a plan may lend its securities to certain parties in interest, provided neither the borrower, nor any affiliate of the borrower, has discretionary authority or control with respect to the investment of plan assets or provides investment advice with respect to those assets.”<sup>181</sup>

Just as section 17(c) of the Investment Company Act permits an affiliate to sell merchandise or lease real property to an investment company in the ordinary course of business, two ERISA class exemptions conditionally permit a party in interest, including any fiduciary, to furnish certain goods to a separate account or collective trust fund, and a separate account or collective trust fund to lease real property to a party in interest.<sup>182</sup> The party in interest must not be the insurance company or bank, another separate account or collective trust fund of that company or bank, or an affiliate of the company or bank.

Again similar to section 17(c), ERISA permits a bank or similar financial institution that is a plan fiduciary to provide an "ancillary service" for reasonable

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<sup>177</sup>PTE 75-1, *supra* note 145, at 50849-50. This class exemption provides relief from both the prohibited transactions provisions of section 406(a) and the fiduciary self-dealing provisions of section 406(b).

<sup>178</sup>*Id.* at 50849.

<sup>179</sup>Class Exemption Covering Certain Short-Term Investments, Prohibited Transaction Exemption 81-8/46 FR 7511 (1981), *amended* 50 FR 14043 (1985).

<sup>180</sup>PTE 75-1, *supra* note 145, at 50850. A registered broker-dealer that is a fiduciary may extend credit to a plan in connection with the purchase or sale of securities under this exemption provided that neither the fiduciary, nor any affiliate of the fiduciary, receives any interest or other consideration in return. *Id.*

“Class Exemption to Permit Certain Loans of Securities by Employee Benefit Plans, Prohibited Transaction Exemption 81-6/46 FR 7527 (1981), *amended* 52 FR 18754 (1987). A plan may lend securities to a party in interest only if the party in interest is a registered broker-dealer, a person exempt from registration as a dealer in exempted government securities, or a bank. *Id.*

<sup>182</sup>PTE 91-38, *supra* note 168, at 31968; PTE 90-1, *supra* note 168, at 2893.

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**compensation.**<sup>183</sup> The bank must adopt safeguards to ensure that the service is provided consistent with sound banking and financial practices and the best interests of participants and beneficiaries of the plan, and not in an excessive or unreasonable manner.<sup>184</sup>

**ERISA** also contains an exemption known as the "multiple services exemption." A person that is a party in interest by virtue of providing certain services to the plan may also provide office space, legal, accounting, and other services necessary for the establishment or operation of the plan, if the plan pays no more than reasonable compensation.<sup>185</sup> A broker-dealer that executes transactions on behalf of a plan (making it a party in interest),<sup>186</sup> may, for example, provide recordkeeping or other necessary services to that plan for reasonable compensation.<sup>187</sup>

## 2. Purchasing an Affiliate's Assets

The Investment Company Act generally prohibits registered investment companies from acquiring securities issued by or any other interest in the business of a broker, dealer, underwriter, or investment adviser.<sup>188</sup> Rule 12d3-1 provides limited exemptions from this requirement but, recognizing the inherent conflict of interest, generally prohibits a registered investment company from acquiring any security issued by its investment adviser, promoter, or principal

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<sup>183</sup>29 U.S.C. § 1108(b)(6).

<sup>184</sup>*Id.* Plan assets held by a bank that is a plan fiduciary which are reasonably expected to be needed to satisfy current plan expenses may be placed by the bank in a non-interest-bearing checking account in the bank if the conditions of regulation 408b-6 are met, notwithstanding the requirement of the statutory exemption for investments in bank deposits that the account bear a reasonable rate of interest. 29 C.F.R. § 2550.408b-6(a). See also 29 U.S.C. § 1108(b)(4) (statutory exemption for bank deposits).

<sup>185</sup>29 U.S.C. § 1108(b)(2). Arrangements for office space or services must be reasonable. The arrangements are exempt only from the prohibited transactions provisions of section 406(a) of ERISA. No relief is provided from the prohibitions on conflicts of interest and self-dealing by fiduciaries under section 406(b) of ERISA. See 29 C.F.R. § 2550.408b-2(a).

<sup>186</sup>See *ERISA and the Investment Management and Brokerage Industries: Five Years Later*, 35 BUS. L. 189,268 (Nov. 1979) [hereinafter ERISA Five Years Later].

<sup>187</sup>See Howard Pianko & Stephen J. Nelson, *Special Issues Involving Broker-Dealers and Their Employee Benefit Plan Clients*, 23 REAL PROP. PROB. & TR. J. 749, 757 (1988) [hereinafter Pianko & Nelson].

<sup>188</sup>See 15 U.S.C. § 80a-12(d)(3). This section provides an exception for corporate issuers all of whose outstanding securities are owned by registered investment companies.

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underwriter, or any affiliated person of such investment adviser, promoter, or principal underwriter that is a "securities related business."<sup>189</sup>

ERISA generally prohibits the acquisition of employer securities and real property by a plan.<sup>190</sup> Section 407 does permit a plan to acquire employer securities or real property if, after the acquisition, the aggregate fair market value of the employer securities and employer real property does not exceed ten percent of the fair market value of the plan's assets.<sup>191</sup> Further, in enacting ERISA, Congress noted that certain kinds of defined contribution plans commonly provide for substantial investments in employer securities and real property.<sup>192</sup>

Congress therefore included an exception in section 407 to allow the practice to continue with respect to certain kinds of defined contribution plans that explicitly provide for investment of more than ten percent of their assets in employer securities and real property.<sup>193</sup> Many defined contribution plans, including 401(k) plans, may thus acquire employer securities and real property in an amount exceeding ten percent of the plan's assets. ERISA further accommodates the use of defined contribution plans for the acquisition of employer securities and real property by excepting these acquisitions from a fiduciary's duty under section 404(a) to diversify a plan's investments.<sup>194</sup>

ERISA permits a plan to invest its assets in deposits in a bank or similar financial institution that is a plan fiduciary if the deposits bear a reasonable rate of interest and the investment is expressly authorized by a provision of the plan

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<sup>189</sup>17 C.F.R. § 270.12d3-1(c).

<sup>190</sup>29 U.S.C. § 1106(a)(2).

<sup>191</sup>Further, under section 407, the plan may only acquire "qualifying employer securities" and "qualifying employer real property." 29 U.S.C. § 1107(a)(1).

<sup>192</sup>U.S. CONGRESS CONFERENCE COMMITTEE, EMPLOYEE RETIREMENT SECURITY ACT OF 1974, H.R. CONF. REP. NO. 1280, 93d Cong., 2d Sess. 317 (1974) [hereinafter ERISA CONFERENCE REPORT].

<sup>193</sup>*Id.* A defined contribution plan relying on this exception must be an "eligible individual account plan" and may acquire only "qualifying employer securities" and "qualifying employer real property." *Id.*

<sup>194</sup>The Department of Labor has also exempted acquisitions of employer securities and employer real property by a collective trust fund or separate account in which a plan is invested, provided the plan's assets constitute no more than 10% of the assets of the collective trust fund or separate account. PTE 91-38, *supra* note 168, at 31966; PTE 90-1, *supra* note 168, at 2891. A collective trust fund or separate account more than 10% of the assets of which are assets of a 401(k) plan or certain other types of defined contribution plan may acquire employer securities or employer real property if certain conditions are met. PTE 91-38, *supra* note 168, at 31968; PTE 90-1, *supra* note 168, at 2893.

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or by a fiduciary other than the bank.<sup>195</sup> A plan may also enter into insurance and annuity contracts with an insurer which is either the employer maintaining the plan or a party in interest which is wholly-owned by the employer maintaining the plan, or by another party in interest with respect to the plan, if the plan pays no more than adequate consideration.<sup>196</sup>

Regulation 9 permits national banks to deposit collective trust fund assets awaiting investment or distribution in their time or savings deposits or those of their affiliates.<sup>197</sup>

### 3. Joint Transactions

Section 17(d) of the Investment Company Act, and rule 17d-1 thereunder, make it unlawful for any affiliated person of or principal underwriter for a registered investment company, or any affiliated person of such a person or principal underwriter, to engage in any transaction in which the registered investment company, or a company controlled by the registered investment company, jointly participates without obtaining prior Commission approval by exemptive application.<sup>198</sup> The rule also provides certain exceptions for which applications are not required.<sup>199</sup> Because of the Commission's broad exercise of its rulemaking authority, many transactions come within rule 17d-1's ambit; these transactions generally require individual approval under a standard that requires the investment company to participate on a basis no less advantageous than that of the other joint participants.<sup>200</sup>

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<sup>195</sup>The approving fiduciary must be expressly authorized by the plan to instruct the trustee with respect to the investment. 29 U.S.C. § 1108(b)(4); 29 C.F.R. § 2550.408b-4.

<sup>196</sup>29 U.S.C. § 1108(b)(5).

<sup>197</sup>12 C.F.R. § 9.18(b)(8)(i).

<sup>198</sup>15 U.S.C. § 80a-17(d); 17 C.F.R. § 270.17d-1(a).

<sup>199</sup>These exceptions include the following: a profit-sharing, stock option, and stock purchase plan covering affiliates or employees of a company controlled by the registered investment company; a qualified employee benefit plan provided by a registered investment company for its employees; certain joint transactions in which a registered investment company and a company that is a "downstream" affiliated person, participate, provided that no "upstream" affiliated persons participate; the receipt of cash or securities by an investment company and its affiliated persons pursuant to the reorganization of a portfolio company; and any arrangement regarding liability insurance policies (other than a fidelity bond required by rule 17g-1). 17 C.F.R. § 270.17d-1(d).

<sup>200</sup>The Commission will also consider whether the registered investment company's participation in the joint transaction is consistent with the Investment Company Act. 17 C.F.R. § 270.17d-1(b).

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Unlike the Investment Company Act, ERISA does not expressly prohibit joint transactions between a plan and a party in interest or fiduciary. The general fiduciary responsibilities imposed by ERISA and the prohibited transactions provisions may nonetheless protect plans from some joint transactions. For example, if a fiduciary participates in a transaction with the plan on its own behalf, it might violate its duty under section 404(a) to act solely in the interests of the participants.

Federal banking law and regulation **9** do not expressly prohibit banks and their affiliates from engaging in joint transactions with their collective trust funds.

#### 4. Underwriting Involving Fiduciaries and Their Affiliates

To prevent dumping of unwanted securities into investment companies' portfolios, section 10(f) of the Investment Company Act prohibits a registered investment company from acquiring any security during the existence of an underwriting or selling syndicate for that security containing an affiliated person (or any person of whom that person is an affiliated person).<sup>201</sup> This prohibition applies only where the affiliate is a "principal underwriter."<sup>202</sup> Where the prohibition applies, the investment company may not purchase the securities from any member of the syndicate. Rule 10f-3 allows a registered investment company to purchase securities in a transaction that would otherwise violate section 10(f) if certain safeguards are met.<sup>203</sup>

ERISA prohibits a plan, during the existence of an underwriting or selling syndicate for a security of which a fiduciary is a member, from purchasing the security from the fiduciary or an affiliate of the fiduciary.<sup>204</sup> Where a fiduciary is a member of the underwriting syndicate for a security, a plan's purchase of those securities during the underwriting from a member of the syndicate other

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<sup>201</sup>See Chapter 12.

<sup>202</sup>*Id.* See 15 U.S.C. § 80a-2(a)(29) (definition of "principal underwriter").

<sup>203</sup>An investment company that engages in transactions in reliance upon rule 10f-3 must report these transactions on its semi-annual report (Form N-SAR) filed with the Commission. 17 C.F.R. § 270.10f-3(g). The investment company's board of directors, including a majority of the disinterested directors, must adopt and periodically review procedures designed to ensure compliance with rule 10f-3 and must determine, at least quarterly, that all transactions during the period were effected in compliance with the rule. 17 C.F.R. § 270.10f-3(h). Rule 10f-3 also prohibits the investment company from acquiring more than the greater of 4% or \$500,000 (but in no case more than 10%) of the principal amount of the offering and from paying an amount greater than 3% of its assets for the acquisition. 17 C.F.R. § 270.10f-3(d)-10f(3)(e).

<sup>204</sup>PTE 75-1, *supra* note 146, at 50848 (the Department of Labor did not specify which prohibited transactions provision(s) would be violated by such purchase).

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than the fiduciary or its affiliate *might* also be a prohibited transaction in that it could constitute a use of plan assets for the benefit of a party in interest.<sup>205</sup>

The Department of Labor has issued a class exemption, Prohibited Transaction Exemption ("PTE") 75-1, that permits a plan to acquire securities, during the existence of an underwriting or selling syndicate, from any person other than the plan's fiduciary (or its affiliate) of the plan that is also a member of such syndicate.<sup>206</sup> No fiduciary involved in causing the plan to purchase securities in a transaction that is exempt under this class exemption may be a "manager" of the underwriting or selling syndicate. The transaction must also meet certain requirements relating to the security, its price, the nature of the underwriting and the extent of a plan's investment.<sup>207</sup> It *might* be a prohibited transaction for a bank participating in an underwriting to have its collective trust fund holding plan assets purchase the securities from another member of the syndicate.<sup>208</sup>

The prohibition under the Investment Company Act seems somewhat broader, affecting more parties and transactions than the ERISA prohibition. Where section 10(f) applies, the investment company may not purchase the securities from any member of the syndicate?'' PTE 75-1 exempts transactions

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<sup>205</sup>See *id.*

<sup>206</sup>PTE 75-1, *supra* note 145, at 50848. If the purchase is from a *non-fiduciary party in interest*, the transaction does not have to comply with this class exemption. However, the transaction would be a principal transaction, prohibited by section 406(a) of ERISA unless exempt under a separate class exemption for principal transactions. See *supra* note 170 and accompanying text (class exemption for principal transactions with *non-fiduciary* parties in interest).

The Department of Labor has stated that the purchase of securities during the existence of an underwriting or selling syndicate for that security, of which a fiduciary or an affiliate thereof is a member, from a member that is not *that* fiduciary or an affiliate thereof will *not* be deemed a prohibited transaction where that fiduciary is not involved in any way in causing the plan to make the purchase, e.g., the fiduciary does not recommend the purchase to the plan or participate in the plan's decision to make the purchase. PTE 75-1, *supra* note 145, at 50848. See also 29 U.S.C. § 1106(b)(1) (use of plan assets for benefit of fiduciary); *ERISA Five Years Later*, *supra* note 186, at 272-73 (purchase from a syndicate member other than the fiduciary *might* benefit the fiduciary because each member may have an interest in the success of the entire offering).

<sup>207</sup>The plan may not acquire more than 3% of the offering or pay an amount greater than 3% of the market value of the plan's assets (or 1% of plan assets if the amount exceeds \$1 million) for the acquisition. PTE 75-1, *supra* note 145, at 50849.

<sup>208</sup>See *id.* at 50848.

<sup>209</sup>Rule 10f-3 provides a safe harbor that conditionally allows an investment company to purchase from members of the syndicate other than the prohibited parties. See 17C.F.R. § 270.10f-3(f).

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between a plan and any syndicate member that is not a plan fiduciary so long as the fiduciary causing the plan to make the purchase (or affiliate) does not serve as manager of the syndicate.<sup>210</sup> Further, the ERISA prohibition only reaches fiduciaries and their affiliates that act as managers -- not other parties in interest. As previously discussed, the Investment Company Act definition of "affiliated person" is substantially broader than the ERISA definitions of "fiduciary" and "affiliate."<sup>211</sup> The Investment Company Act prohibitions thus reach more persons with potential conflicts of interest.

Another significant difference between the Investment Company Act and ERISA anti-dumping provisions is that the ERISA class exemption permits the purchase of any security issued by a bank, whether or not registered and regardless of quality, and certain other types of unregistered securities.<sup>212</sup> Rule 10f-3 exempts only purchases of securities registered under the Securities Act and municipal securities and then only if the securities have at least an investment grade rating (for municipal securities)<sup>213</sup> or the issuers are "seasoned" (for registered securities). Securities acquired under the class exemption must also be seasoned (*i.e.*, the issuer must have been in continuous operation for at least three years), but securities "fully guaranteed" by a bank or certain others are excepted from the seasoning requirement. By more closely restricting the availability of its anti-dumping safe harbor to securities that are rated or that have been registered under a statute with civil liabilities for material misstatements and omissions, the Investment Company Act more successfully removes the opportunity for the dumping of securities by affiliated underwriters.

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<sup>210</sup>It may still be a prohibited transaction for a plan to purchase securities offered in an underwriting from a member of the syndicate other than the fiduciary or its affiliate if the fiduciary profits from the transaction. See Pianko & Nelson, *supra* note 187, at 763.

<sup>211</sup>See *supra* notes 155, 156 and accompanying text.

<sup>212</sup>PTE 75-1, *supra* note 145, at 50848. Securities issued or guaranteed by a bank are generally not subject to the registration requirements of the 1933 Act. See Securities Act § 3(a)(2), 15 U.S.C. § 77c(a)(2). Further, the class exemption allows the purchase of securities (1) issued by a common or contract carrier under the Interstate Commerce Act, (2) exempt from registration by a federal statute other than the Securities Act, or (3) the subject of a distribution and of a class required to be registered under section 12 of the Exchange Act and the issuer of which has been subject to the reporting requirements of section 13 of the Exchange Act for at least 90 days and has filed all required reports with the Commission during the preceding year. PTE 75-1, *supra* note 145, at 50848.

<sup>213</sup>See 17 C.F.R. § 270.10f-3(c). If the municipal issuer has been in continuous operation for less than three years, the issue must receive one of the three highest ratings. Id.

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## 5. Use of Offering Proceeds to Retire Debts to Affiliates

The Commission has supported legislation that would specifically prohibit an investment company from acquiring, during the existence of an underwriting or selling syndicate, securities of an issuer that will use the proceeds of the offering to defray indebtedness owed to an entity that is an affiliated person of the investment company.<sup>214</sup> The Investment Company Act currently does not explicitly proscribe such activity. This legislation is needed to prevent banks and others from using affiliated investment companies as a source of capital to bail out themselves or their financially troubled debtors or to otherwise further its own interest as creditor of such issuers.<sup>215</sup>

ERISA generally prohibits the use of offering proceeds to retire debts to affiliates, but the Department of Labor has issued a class exemption permitting a plan to purchase securities in two situations where the offering proceeds would be so used. First, the class exemption conditionally allows a fiduciary that is a bank or an affiliate thereof to purchase securities on behalf of a plan in a public offering where the proceeds *may* be used by the issuer to retire or reduce indebtedness owed to that fiduciary or its affiliate.<sup>216</sup> If the fiduciary "knows" that the proceeds of the issue will be used by the issuer to reduce or retire indebtedness owed to that fiduciary or its affiliate, the transaction must comply with several additional conditions relating to the timing and terms of the purchase, the nature of the offering, and the extent of the plan's participation. Second, the class exemption conditionally allows a plan fiduciary to purchase securities on behalf of a plan in a public offering where the issuer may use the proceeds of the offering to retire or reduce indebtedness owed to a party in interest other than the fiduciary.<sup>217</sup> The class exemption does not apply if the securities to be purchased are issued by the employer or any affiliate of the employer.

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<sup>214</sup>See, e.g., *The Securities Regulatory Equality Act of 1991: Hearings on H.R. 797 Before the Subcomm. on Telecommunications and Finance of the House Comm. on Energy and Commerce*, 102d Cong., 1st Sess. (1991) (statement of Richard C. Breeden, Chairman, SEC) [hereinafter H.R. 797 Testimony]; *Hearings on S. 543 and S. 713 Before the Senate Comm. on Banking, Housing, and Urban Affairs*, 102d Cong., 1st Sess. (1991) (statement of Richard C. Breeden, Chairman, SEC); see also S. 543, 102d Cong., 1st Sess. § 742(a) (1991); H.R. 6, 102d Cong., 1st Sess. § 462(b) (1991).

<sup>215</sup>In connection with any such legislation, the Commission has stated that it should be given the authority to exempt proposed transactions from such a prohibition in the interest of investment company shareholders. See H.R. 797 Testimony, *supra* note 214, at 21.

<sup>216</sup>See Class Exemption for Certain Transactions Involving Purchase of Securities Where Issuer May Use Proceeds to Reduce or Retire Indebtedness to Parties in Interest, Prohibited Transaction Exemption 80-83, 45 FR 73189 (1980).

<sup>217</sup>*Id.*

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Regulation 9 does not specifically prohibit a collective trust fund from investing in securities where the offering proceeds will be used by the issuer to reduce or retire indebtedness owed to the bank or an affiliate of the bank.<sup>218</sup>

## 6. Agency Transactions by Affiliates

The Investment Company Act does not prohibit all affiliated agency transactions. Instead, section 17(e) establishes limits within which an affiliate, acting as agent, may receive compensation in connection with the purchase or sale of any property from or to the investment company. The transaction must be in the course of the affiliate's business as an underwriter or broker. Any commissions received by an affiliated person acting as broker must meet the limitations of section 17(e)(2).<sup>219</sup> Further, an investment adviser has a duty to obtain best execution for transactions in which it has brokerage discretion.

Section 406 of ERISA generally prohibits a party in interest from acting as agent for a plan. Because service providers are, by definition, parties in interest, ERISA section 408 exempts certain essential services from section 406.<sup>220</sup> In addition, the Department of Labor has issued class exemptions to enable plans to obtain certain services from fiduciaries and other parties in interest. One class exemption conditionally permits a plan fiduciary to execute securities transactions for a plan for a fee, if the transactions are not "excessive, under the circumstances, in either amount or frequency."<sup>221</sup> Further, a plan fiduciary may generally act as the agent in an agency cross transaction involving the plan and receive reasonable compensation from the plan and the other parties to the

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<sup>218</sup>The Glass-Steagall Act prohibition of stock underwriting by commercial banks and their affiliates has significantly eroded. Recently, J.P. Morgan Securities, an affiliate of Morgan Guaranty, helped underwrite a public offering of common stock. The issuer planned to use about 18% of the proceeds of the offering to pay off part of its indebtedness to Morgan Guaranty, the lead commercial bank for its line of credit. See David B. Hilder, *Stock Offering Shows Hurdles Faced by Banks*, WALL ST. J., Feb. 25, 1991, at A5.

<sup>219</sup>Section 17(e)(2)(A) limits an affiliated broker's commission on transactions effected on an exchange to the "usual and customary broker's commission;" rule 17e-1, a safe harbor under section 17(e)(2)(A), permits commissions that are reasonable and fair compared to commissions paid to other brokers involving similar transactions. 17 C.F.R. § 270.17e-1.

<sup>220</sup>See *supra* notes 183, 185 and accompanying text.

<sup>221</sup>Class Exemption for Securities Transactions Involving Employee Benefit Plans and Broker-Dealers, Prohibited Transaction Exemption 86-128, 51 FR 41686, § II(a) (1986) [hereinafter PTE 86-128].

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transaction.<sup>222</sup> A plan fiduciary that is a discretionary trustee or administrator of the plan, or an employer whose employees are covered by the plan, may engage in agency or agency cross transactions with the plan only if it returns or credits to the plan all "profits"<sup>223</sup> it earns in those transactions.<sup>224</sup>

An independent fiduciary of a plan must give written authorization in advance for any agency or agency cross transaction executed by a fiduciary and the executing fiduciary must furnish the authorizing fiduciary with certain disclosures. A fiduciary engaging in agency cross transactions with a plan must provide additional disclosures beyond those required when the fiduciary executes transactions on behalf of the plan. The fiduciary executing an agency cross transaction may have investment discretion and/or render investment advice only with respect to either buyers or sellers in the transaction, but not both.<sup>225</sup>

While a service provider is not always a plan fiduciary, it is always a party in interest and therefore subject to the prohibited transactions provisions under ERISA section 406(a). A party in interest, or an affiliate of a party in interest, may provide, by class exemption, the following services to the plan: effecting securities transactions on behalf of the plan, acting as agent for the plan, performing clearance, settlement, and custodial functions incidental to effecting transactions, and providing investment advice and analyses to the plan under circumstances which do not make the party in interest a fiduciary of the

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<sup>222</sup>*Id.* at 41695. This class exemption only exempts transactions from the fiduciary self-dealing and conflicts provisions of section 406(b) of ERISA, not from the prohibited transactions provisions of section 406(a). If a plan fiduciary purchases securities for the plan from a person the fiduciary knows is a party in interest in an agency cross transaction and the fiduciary receives a commission from the party in interest for effecting a transaction, the fiduciary will not be deemed to have received a kickback in violation of section 406(b)(3). *Id.* at 41690. However, the purchase of the securities on behalf of the plan from the party in interest would still be a prohibited transaction under section 406(a)(1). *Id.*

<sup>223</sup>"Profit" is defined to allow a discretionary trustee, plan administrator, or employer to recoup its expenses, **both** direct and indirect, including overhead. *Id.* at 41694.

<sup>224</sup>See *id.* at 41696. A bank that maintains a collective trust fund would be a discretionary trustee and thus a plan fiduciary of a plan that invests in the fund. That bank cannot execute securities transactions on behalf of the plan as agent for the plan or engage in agency cross transactions involving the plan unless the bank returns or credits to the plan all "profits" it earns in connection with those transactions. *Id.*

<sup>225</sup>The conditions for engaging in agency cross transactions do not apply in every case. A fiduciary may engage in agency cross transactions with **the** plan if it, in effect, is not acting **as** a fiduciary with respect to the plan assets used for the transaction. *Id.* at 41696.

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plan.<sup>226</sup> A fiduciary of a plan cannot rely upon this class exemption.<sup>227</sup> Each exempted transaction must be effected on behalf of the plan, and any advice or analysis must be provided to the plan, on terms that are at least as favorable to the plan as would be obtained in an arm's length transaction with an unrelated party.

While regulation 9 is largely silent on affiliates acting as agent to a collective trust fund, the Comptroller has construed regulation 9 to prohibit national banks from engaging in securities transactions for trust accounts they administer through an affiliated discount broker except where neither the bank nor the affiliated broker profits from the transaction.<sup>228</sup> However, a bank may execute transactions through an affiliated broker if authorized by the trust instrument, local law, or the trust beneficiaries.<sup>229</sup>

### C. Fund Management

The Investment Company Act subjects the management of a registered investment company to extensive regulation.<sup>230</sup> A majority of shareholders must approve any change in its fundamental policies and certain changes in its investment policies.<sup>231</sup> A registered investment company must obtain shareholder approval to vary the fund's policies described in the registration statement regarding borrowing money, issuing senior securities, underwriting other issuers' securities, purchasing or selling real estate or commodities, or making loans to other persons.<sup>232</sup> Shareholders elect the investment company's

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<sup>226</sup>See PTE 75-1, *supra* note 145, at 50846.

<sup>227</sup>Fiduciaries may execute transactions for a plan as previously discussed. See PTE 86-128, *supra* note 221 and accompanying text (execution of transactions by a fiduciary).

<sup>228</sup>OFFICE OF THE COMPTROLLER OF THE CURRENCY, Trust Banking Circular No. 23 (Oct. 4, 1983), 5 Fed. Banking L. Rep. (CCH) ¶ 60,575. A bank or its affiliate may impose a fee to cover the cost of the transaction. *Id.*

<sup>229</sup>*Id.*

<sup>230</sup>See Chapter 7.

<sup>231</sup>See 15 U.S.C. § 80a-13(a)(3).

<sup>232</sup>15 U.S.C. § 80a-13(a)(2).

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board of directors.<sup>233</sup> Shareholders must also approve any amendments to the investment advisory contract.<sup>234</sup>

ERISA requires that every covered employee benefit plan be established under a written instrument which provides for one or more "named fiduciaries" to manage and control the operation and administration of the plan.<sup>235</sup> All assets of the plan must be held in trust by one or more trustees:<sup>36</sup> except for plan assets held by an insurance company.<sup>237</sup> The plan may provide that a named fiduciary with responsibility for managing the plan assets may appoint an investment manager to manage those assets.<sup>238</sup> The appointed investment manager must be a bank, insurance company or registered investment adviser and must acknowledge, in writing, that it is a fiduciary of the plan.<sup>239</sup> Under ERISA, participants in employee benefit plans are generally not entitled to vote on any matter affecting the management of the plan. Rather, ERISA regulates the management of plan assets by establishing certain basic duties of plan fiduciaries under section 404(a).<sup>240</sup>

A bank collective trust fund must be established pursuant to a written plan.<sup>241</sup> Participants in bank collective trust funds are not entitled to vote on any matters with respect to the funds. A collective trust fund's fundamental policies may be changed without the approval of representatives of participating plans.<sup>242</sup> Regulation 9 requires that the bank have the exclusive management

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<sup>233</sup>15 U.S.C. § 80a-16.

<sup>234</sup>15 U.S.C. § 80a-15(a). In connection with shareholder votes, an investment company must file proxies containing the disclosures specified under the proxy rules of the Exchange Act, including certain additional information where a proxy relates to the election of directors or approval of the investment advisory contract. 17 C.F.R. §§ 270.20a-1, 270.20a-2, 270.20a-3.

<sup>235</sup>29 U.S.C. § 1102(a).

<sup>236</sup>29 U.S.C. § 1103(a).

<sup>237</sup>29 U.S.C. § 1103(b).

<sup>238</sup>29 U.S.C. § 1102(c)(3).

<sup>239</sup>29 U.S.C. § 1002(38).

<sup>240</sup>See *supra* notes 133-137 and accompanying text.

<sup>241</sup>12 C.F.R. § 9.18(b)(1). A collective trust fund's written plan must be approved by the bank's board of directors and filed with the Comptroller. *Id.*

<sup>242</sup>Apparently the plan may be amended by the bank's board of directors. See Martin E. Lybecker, *Bank-Sponsored Investment Management Services: Consideration of the Regulatory Problems*, (continued...)

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of a collective investment fund.<sup>243</sup> Regulation 9 also requires that a periodic audit be made by auditors responsible only to the bank's board of directors.<sup>244</sup>

#### D. Valuation and Redemption

Open-end investment companies generally must value their portfolios on a "mark-to-market" basis daily. This requirement assures that fund assets are valued accurately and that sales and repurchases of fund shares occur at prices that prevent the interests of new, existing, or redeeming shareholders from being diluted. Investment company securities may not be sold or redeemed except at a price based on their current net asset value which is next computed after receipt of a redemption or purchase order. Rule 22c-1 generally requires a registered open-end investment company to calculate its current net asset value per share at least daily. Under section 22(e) of the Investment Company Act, an investor tendering shares for redemption generally must be paid within seven days of tender.

The regulations adopted under the Internal Revenue Code provide that a qualified pension plan is a plan established primarily to provide *retirement* benefits.<sup>245</sup> Accordingly, defined contribution plan participants generally cannot redeem their investments before they retire or cease working for their employer, in which case they are entitled to receive the vested portion of their individual accounts. Some defined contribution plans allow participants to withdraw their own account contributions.<sup>246</sup> A qualified pension plan may not, however, permit participants to withdraw the employer's contributions prior to retirement, termination of employment, or termination of the plan.<sup>247</sup> Participants in participant-directed defined contribution plans are allowed to transfer funds among the investment options available under the plan, in accordance with the terms of the plan. Defined contribution plans must value

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<sup>242</sup>(...continued)

and Suggested Legislative and Statutory Interpretive Responses, 1977 DUKE L.J. 983, 1032 (regulation 9 does not contain any restriction on changing a collective trust fund's investment policy once the fund is established).

<sup>243</sup>12 C.F.R. § 9.18(b)(12).

<sup>244</sup>12 C.F.R. § 9.18(b)(5)(i).

<sup>245</sup>See 26 C.F.R. § 1.401(b)(1)(i).

<sup>246</sup>See Rev. Rul. 69-277, 1969-1 C.B. 116.

<sup>247</sup>See Rev. Rul. 74-417, 1974-2 C.B. 131; Rev. Rul. 74-254, 1974-1 C.B. 91.

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each individual account at least annually, on a specified date.<sup>248</sup> The plan must use the fair market value of the plan assets as of the valuation date in determining the value of the individual accounts.<sup>249</sup>

Bank collective trust funds are required to describe in their written plans the basis and method used to value the fund assets, and generally to value their assets at market value.<sup>250</sup> Plans invest in and withdraw from bank collective trust funds on the basis of this valuation, which must be made at least quarterly.<sup>251</sup>

### **E. Advertising**

Investment companies must file copies of the full text of their sales literature with the Commission, or the **NASD**, not later than ten days after they are transmitted or distributed to prospective investors.<sup>252</sup> If a registered investment company chooses to advertise its performance, it must do so in accordance with rules that standardize and prescribe certain performance indicators. Generally, a registered investment company is required to portray total return data for one, five, and ten year periods. If an investment company advertises its yield, it must use a standardized thirty day yield. Investment companies, bank collective trust funds, and insurance company separate accounts are subject to the antifraud provisions of section 10(b) of the Exchange Act, rule 10b-5 thereunder, and section 17(a) of the Securities Act.

**ERISA** does not specifically address the promotion or advertisement of pooled investment vehicles.

The Comptroller generally permits unrestricted advertising of collective trust funds, except that advertisement of future performance or comparative performance with funds other than those offered by the bank is not permitted. National banks are not required to file copies of collective trust fund sales literature with the Comptroller, although the Comptroller does monitor such

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<sup>248</sup>Rev. Rul. 80-155, 1980-1 C.B. 84, 85.

<sup>249</sup>*Id.*

<sup>250</sup>12 C.F.R. §§ 9.18(b)(1), 9.18(b)(15).

<sup>251</sup>12 C.F.R. § 9.18(b)(4).

<sup>252</sup>15 U.S.C. § 80a-24(b); 17 C.F.R. 270.24b-3.

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advertisements for compliance with the antifraud provisions of the securities laws.<sup>253</sup>

## F. Diversification

To qualify for pass-through tax treatment, an investment company must meet the Internal Revenue Code's two-part diversification standard. First, with respect to fifty percent of an investment company's assets, no more than five percent may be invested in the securities of any one issuer and the investment company may not own more than ten percent of the outstanding voting securities of any one issuer. Second, as to 100% of the investment company's assets, no more than twenty-five percent may be invested in the securities of any one issuer.<sup>254</sup>

Under **ERISA**, plan fiduciaries are required to ensure that the plan's investments are diversified to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so.<sup>255</sup> Failure of a plan's investment manager to investigate the plan's cash flow requirements and to adequately diversify the plan's investments to meet its liquidity needs is a breach of fiduciary duty for which the manager may be liable.<sup>256</sup> The Conference Committee's report on the adoption of **ERISA** states that, with respect to the requirement of diversification, the fiduciary should consider factors such as (1) the purposes of the plan; (2) the amount of the plan assets; (3) financial and industrial conditions; (4) the type of investment; (5) distribution as to geographical location; (6) distribution as to industries; and (7) the dates of maturity.<sup>257</sup> In determining whether plan assets are sufficiently diversified, the fiduciary should look to the plan's underlying assets held in a mutual fund, bank collective fund, or insurance company separate account.<sup>258</sup>

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<sup>253</sup>COMPTROLLER OF THE CURRENCY, COMPTROLLER'S HANDBOOK FOR FIDUCIARY ACTIVITIES **243** (Sept. 1990).

<sup>254</sup>26 U.S.C. § 851.

<sup>255</sup>29 U.S.C. § 1104(a)(1)(C).

<sup>256</sup>See **GIW** Industries, Inc. v. Trevor, Stewart, Burton & Jacobsen, Inc., 895 F.2d 729 (11th Cir. 1990).

<sup>257</sup>Similarly, diversification could be achieved through the use of several different investment managers, each of whom concentrated in specific forms of investment, so long as the portfolio of the plan as a whole was diversified. See ERISA CONFERENCE REPORT, *supra* note 193, at 304.

<sup>258</sup>*Id.* Investments of a separate account underlying a variable annuity, endowment, or life insurance contract are adequately diversified if (1) no more than 55% of the value of its assets is represented by any one investment; (2) no more than 70% is represented by any two investments; (continued...)

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Regulation 9 does not specifically require that collective trust funds diversify their investments, except that the fund must be maintained as set forth in the written plan.<sup>259</sup>

### G. Liquidity

All three regulatory frameworks impose requirements that an investment vehicle maintain a sufficient portion of its assets in liquid investments. Open-end investment companies generally may not invest more than fifteen percent of their net assets in illiquid investments.<sup>260</sup> ERISA's prudence standard includes a requirement to consider liquidity needs in the management of plan assets.<sup>261</sup> Collective trust funds, other than short-term investment funds,<sup>262</sup> may invest any percentage of their assets in illiquid investments consistent with anticipated redemption needs.

## VI. Conclusion

As the foregoing somewhat lengthy analysis shows, ERISA and, to a lesser extent, the Comptroller's rules provide important safeguards to ensure that plan participants will receive the benefits at retirement that they both expect and need. Nonetheless, participants increasingly are expected to rely on the investment performance of their individual accounts to provide their retirement benefits.

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<sup>258</sup>(...continued)

(3) no more than 80% is represented by any three investments; and (4) no more than 90% is represented by any four investments. 26 CFR. § 1.817-5; see also Announcement 88-68, 1988-16 IRB. 36 (diversification requirements for variable annuity, endowment and life insurance contracts).

<sup>259</sup>By contrast, a bank's common trust fund may not invest more than 10% of its assets in securities of any one issuer. See 12 C.F.R. § 9.18(b)(9)(ii).

<sup>260</sup>See Guide 4 to Form N-1A, Investment Company Act Release No. 18612 (March 12, 1992), 57 FR 9828; Restricted Securities, Investment Company Act Release No. 5847 (Oct. 21, 1969), 35 FR 19989. The Commission has stated that an "illiquid security" generally is any security that cannot be disposed of within seven days in the ordinary course of business at approximately the amount at which the investment company has valued the instrument. See Resale of Restricted Securities, Securities Act Release No. 6862 (April 23, 1990), 55 FR 17933 (adopting rule 144A under the Securities Act); Acquisition and Valuation of Certain Portfolio Instruments by Registered Investment Companies, Investment Company Act Release No. 14983 (Mar. 12, 1986), 51 FR 9773 (adopting amendments to rule 2a-7).

<sup>261</sup>29 C.F.R. § 2550.404a-1(b)(2)(ii)(B).

<sup>262</sup>See 12 C.F.R. § 9.18(b)(15)(i), 9.18(b)(15)(iv) (liquidity requirements for short-term investment funds).

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Further, a growing number of plans are requiring that the participants, themselves, decide how to invest their individual accounts.

For many pension plan participants, choosing where to invest their retirement plan assets will be the most important investment decision they will ever make. Participants need to be furnished complete information about their investment options, both concerning initial investment decisions (*i.e.*, prospectuses) and reallocations (*i.e.*, prospectuses and shareholder reports). To provide employees with adequate information about their investment decisions, legislation is needed to (1) amend section 3(a)(2) of the Securities Act to remove the exception for interests in collective trust funds and separate accounts in which participant-directed defined contribution plans invest, and (2) amend the federal securities laws to require delivery of prospectuses for the underlying investment vehicles, including investment companies, to plan participants who direct their investments (see Table 3-2 for a summary of our proposed legislative changes). Further, to provide employees with adequate information to enable them to monitor their investments' performance, the Exchange Act and the rules under the Investment Company Act should be amended to ensure that all plan participants receive semiannual and annual shareholder reports issued by the pooled investment vehicles in which they invest.

We do not recommend that Investment Company Act regulation (other than the shareholder reporting provisions) be imposed on collective trust funds and separate accounts in which employee benefit plans invest. The participants in these plans are sufficiently protected by other regulatory schemes, and the additional benefits to be derived by imposing Investment Company Act regulation are outweighed by the costs.

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**Table 3-2**

**Summary of *Status Quo* and Recommendations**

**Current Federal Securities Law**

**Defined Benefit Plans (and Non-participant-Directed Defined Contribution Plans)**

1. Interests in defined benefit plans excepted from Securities Act and Exchange Act registration and plans excepted from Investment Company Act regulation.
2. Interests in collective trust funds and separate accounts consisting solely of assets of defined benefit plans excepted from Securities Act and Exchange Act registration and the funds and separate accounts excepted from Investment Company Act regulation.
3. Neither prospectuses nor semiannual reports for underlying investment vehicles of defined benefit plans required to be delivered to plan participants under federal securities laws.

**Participant-Directed Defined Contribution Plans**

1. Interests in participant-directed defined contribution plans excepted from Securities Act registration (except plans that invest employee contributions in employer stock) and Exchange Act registration, and plans excepted from Investment Company Act regulation.
2. Interests in collective trust funds and separate accounts containing assets of participant-directed defined contribution plans excepted from Securities Act and Exchange Act registration and the funds and separate accounts excepted from Investment Company Act regulation.
3. Neither prospectuses nor semiannual reports for underlying investment vehicles of participant-directed defined contribution plans required to be delivered to plan participants under federal securities laws.

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## Recommendations

1. Interests in defined benefit plans excepted from Securities Act and Exchange Act registration and plans excepted from Investment Company Act regulation.
1. Interests in participant-directed defined contribution plans excepted from Securities Act registration, except plans that invest employee contributions in employer stock and Exchange Act registration, and plans excepted from Investment Company Act regulation.
2. Interests in collective trust funds and separate accounts consisting solely of assets of defined benefit plans excepted from Securities Act and Exchange Act registration and the funds and separate accounts excepted from Investment Company Act regulation.
2. Interests in collective trust funds and separate accounts containing assets of participant-directed defined contribution plans required to be registered under the Securities Act, but the funds and separate accounts excepted from Investment Company Act regulation.
3. Neither prospectuses nor semiannual reports for underlying investment vehicles of defined benefit plans required to be delivered to plan participants under federal securities laws.
3. Federal securities laws amended to require that participants in participant-directed defined contribution plans *receive* prospectuses and shareholder reports for the underlying investment vehicles in which the plan invests.

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## APPENDIX 3-A

### Chronology

- 1938: Section 165 of Internal Revenue Code enacted.
- 1940: Investment Company Act enacted. Section 3(c)(13) excepts employee benefit plans qualified under section 165 of Internal Revenue Code.
- Late 1940's: Rapid growth of corporate pension plans begins.
- 1955: Federal Reserve Board amends regulation F, permitting collective investment of pension assets.
- 1956: Internal Revenue Service rules that collective trust funds, and pension plans whose assets are invested collectively, qualify under section 401 (successor to section 165).
- Late 1950's: State legislation permits insurance companies to establish separate accounts to fund pension plans.
- 1962: Section 401 amended to create H.R. 10 ('Keogh') plans.
- 1962-63: Comptroller of the Currency assumes authority over collective trust funds of national banks, adopts regulation 9.
- 1963-69: Commission adopts rules exempting separate accounts from various provisions of Investment Company Act.
- 1963: Commission construes section 3(c)(13) of Investment Company Act to apply to Keogh plans and collective trust funds containing Keogh plan assets.
- 1968: Commission staff takes position that interests in collective trust funds must be registered under Securities Act if the participating plans were voluntary and contributory.
- 1970: Section 3(c)(13) amended, changed to section 3(c)(11). Collective trust funds and separate accounts containing solely assets of section 401 pension plans excepted from Investment Company Act regulation. Section 3(a)(2) of Securities Act amended to except interests in collective trust funds and separate accounts, except interests sold to Keogh plans. Interests in a plan under which employee contributions are invested in employer stock also required to register under Securities Act.

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- 1974: ERISA enacted.
  - 1978: 401(k) plans created by amendment to section 401 of Internal Revenue Code.
  - 1979: Supreme Court holds that interests in involuntary, noncontributory pension plans are not securities.
  - 1980: Securities Act and Investment Company Act amended to except governmental plans, collective trust funds and separate accounts containing governmental plan assets, and interests therein.
  - 1980-81: Commission issues interpretive releases clarifying staff's treatment of pension plans under Securities Act.
  - 1981: Commission adopts rule 180 conditionally excepting collective trust funds and separate accounts in which certain Keogh plans invest.
  - 1981: IRS permits employees to make pre-tax contributions to 401(k) plans through salary reduction.

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## Chapter 4

# Internationalization and Investment Companies

### I. Introduction and Summary of Recommendations

Internationalization is perhaps the most significant development in the United States and world securities markets in recent years. Accelerated by technological advances and the removal of many legal impediments to foreign participation, world markets have become internationalized to an unprecedented degree?

The increased levels of cross-border sales of securities have been fostered in part by and have encouraged regulatory reform. As reported by the Organisation for Economic Co-operation and Development, "[t]here is no other sector within the broad area of the financial services markets in which such a large number of organizational and regulatory changes has taken place as has been the case in the field of securities-related activities."<sup>2</sup> In the United States, Congress and the Commission have demonstrated a firm commitment to regulatory reform that facilitates internationalization and also maintains investor protection.

As trade, communication, and technological developments have fueled internationalization of the markets generally, they have stimulated interest in investment companies that offer diversified portfolios of foreign securities. Recent global stock market volatility also has heightened interest in these funds.<sup>3</sup>

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<sup>1</sup>According to figures compiled by the Commission's Office of Economic Analysis, in **1990**, foreign purchases and sales of United States securities were over 20 times higher than they were in **1980**, rising from **\$198.1** billion to **\$4.2** trillion. That same year, United States purchases and sales of foreign securities grew to a level approximately **16** times higher than that in **1980**, from **\$53.1** billion to **\$902.9** billion.

<sup>2</sup>ORGANIZATION FOR ECONOMIC COOPERATION AND DEVELOPMENT, FINANCIAL MARKET TRENDS **18** (May 1990).

<sup>3</sup>See Jim Freer, *International Investors Seek Added Diversity*, INT'L BUS. CHRON., Oct. **29** - Nov. **11, 1990**, at **16**; see also Terry M. Chuppe, Hugh R. Haworth, & Marvin G. Watkins, The Securities Markets in the **1980s**: A Global Perspective 84-88 (Jan. **26, 1989**) (unpublished manuscript, on file with the Securities and Exchange Commission) (citing factors precipitating recent surge in global portfolio investments).

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Although investors worldwide appear more eager than ever to diversify their investments with managed portfolios of foreign securities, access by United States investors to foreign investment companies and by foreign investors to United States investment companies generally remains limited. Despite some evidence that cross-border sales of investment company securities are on the rise,<sup>4</sup> the Division believes cross-border sales do not constitute a significant percentage of total fund sales?

United States investors seeking managed portfolios of foreign investments generally invest in United States-registered funds that concentrate investments in foreign issuers. A growing number of United States-registered investment companies hold foreign securities in their portfolios. For example, the number of United States-registered open-end international equity funds rose from approximately 25 in 1985 to 145 as of December 31, 1991.<sup>6</sup> The number of United States-registered closed-end "country" funds grew from 3 in 1985 to 33 as of December 31, 1991.<sup>7</sup>

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<sup>4</sup>Foreign investors are purchasing more shares of investment companies generally. Reports published by the United States Department of the Treasury on foreign investment in selected United States mutual funds show a nearly 92% increase in the total dollar amount invested by foreign investors from 1978 to 1984 (from \$1,134,000,000 to \$2,173,000,000). DEPT OF THE TREASURY, REPORT ON FOREIGN PORTFOLIO INVESTMENT IN THE UNITED STATES AS OF DEC. 31, 1984, at Table A.8 (1989); DEPT OF THE TREASURY, REPORT ON FOREIGN PORTFOLIO INVESTMENT IN THE UNITED STATES AS OF DEC. 31, 1978, at Table A.3 (1980).

<sup>5</sup>Data on the extent of cross-border sales by foreign investment companies to United States investors or by United States investment companies to foreign investors are limited. The Commission is not able to monitor the nature and extent of foreign investment in United States funds or track United States investment in foreign funds. While the Departments of the Treasury and Commerce and the Board of Governors of the Federal Reserve System collect extensive data concerning cross-border investment, none has comparative data for investment companies. The Department of the Treasury does monitor foreign investment in United States mutual funds, but it provides data on only certain United States investment companies. Although the largest United States investment company industry association, the Investment Company Institute, collects extensive data on the domestic activities of its members, it does not track their overseas activities.

<sup>6</sup>These 145 international equity funds (excluding global funds) held total assets of approximately \$18.5 billion as of December 31, 1991. International equity funds invest their assets mostly in securities whose primary trading markets are outside the United States. LIPPER ANALYTICAL SERVICES, INC., DIRECTORS' ANALYTICAL DATA (1st ed. 1992) [hereinafter DIRECTORS' ANALYTICAL DATA].

<sup>7</sup>These 33 single country funds held total assets of approximately \$4.2 billion as of December 31, 1991. UPPER ANALYTICAL SERVICES, INC., CLOSED-END PERFORMANCE ANALYSIS SERVICE 44 (Jan. 31, 1992). Country funds invest their assets primarily in the securities of issuers domiciled in a particular country or region. In addition, the number of United States global funds (which invest at least 25% of their assets in securities traded outside the United States) rose from 16 as of (continued...)

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There has been a great deal of debate on how best to increase cross-border sales of investment company shares.<sup>8</sup> In the European Community, this debate resulted in the European Council Directive of 20th December 1985 on the Coordination of Laws, Regulations and Administrative Provisions Relating to Undertakings for Collective Investment in Transferable Securities ("UCITS Directive").<sup>9</sup> The UCITS Directive prescribes a common denominator approach to protecting investors in certain open-end investment companies qualifying as UCITS. A UCITS from one European Community Member State

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<sup>7</sup>(...continued)

December 31, 1985, with total assets of \$6.57 billion, to 71 as of December 31, 1991, with total assets of \$18.8 billion. The number of world income funds (which invest in both United States dollar and non-United States dollar debt instruments) grew from 1 as of December 31, 1985, with total assets of \$61.2 million, to 88 as of December 31, 1991, with total assets of \$29.4 billion. DIRECTORS' ANALYTICAL DATA, *supra* note 6.

<sup>8</sup>In response to the Commission's request for public comment on cross-border sales, SEC Request for Comments on Reform of the Regulation of Investment Companies, Investment Company Act Release No. 17534 (June 15, 1990), 55 FR 25322 [hereinafter Study Release], the Commission received comments from the American Bar Association (Section of Business Law); American Council of Life Insurance; Amsterdam Stock Exchange; Banca d'Italia (Italy); Bankers Trust Company; Benham Management Group; Bundesaufsichtsamt fur das Kreditwesen (Germany); Calvert Group, Ltd.; Central Bank of Ireland; The Chase Manhattan Bank, N.A.; Citicorp; Cleary, Gottlieb, Steen & Hamilton; République Française, Commission des Operations de Bourse (France); Commission des valeurs mobilières du Québec; DFA Investment Dimensions Group, Inc. and Dimensional Fund Advisors, Inc.; the Danish Supervisory Authority (Finanstilsynet); Davis Polk & Wardwell; Dechert Price & Rhoads; The Equitable Life Assurance Society of the United States; Federated Investors; the Independent Trustees of the Fidelity Funds; Fidelity Management & Research Company; French Bankers' Association (Association Française des Banques); Timothy J. Gallagher; IDS Financial Services, Inc.; Leslie L. Ogg, Vice President, General Counsel and Treasurer, IDS Mutual Fund Group; Investment Company Institute; the Japanese Government, Ministry of Finance; Howard Kaikow; Linklaters & Paines; Los Angeles County Bar Association, Business and Corporations Law Section (certain committee members); Merrill Lynch & Co., Inc.; Robert G. Miller; Office of the Secretary of State of Missouri; The New York Clearing House Association; North American Securities Administrators Association, Inc.; Prudential Mutual Fund Management, Inc.; The Putnam Companies; Ropes & Gray; Scudder, Stevens & Clark, Inc.; Securities and Investments Board (United Kingdom); Shearson Lehman Brothers Inc.; State Street Bank and Trust Company; Jan Stenbeck, Shareholder and Director of Industriforvaltnings AB Kinnevik; Swedish Bank Inspection Board (Bankinspektionen); Kathleen A. Veach, Mutual Fund Examiner, Ohio Department of Commerce, Division of Securities; Warburg Investment Management International Ltd.; S.G. Warburg & Co., Inc.; Wayne Hummer Growth Fund Trust and Wayne Hummer Money Fund Trust; Westpac Banking Corporation; and the State of Wisconsin (Office of the Commissioner of Securities).

<sup>9</sup>Council Directive 85/611, 1985 O.J. (L 375) 3.

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may sell its shares in any other Member State, subject only to the host country's marketing, advertising, and tax laws.<sup>10</sup>

In the United States, many in the investment company industry believe that changes in domestic policy are necessary for more receptive treatment of United States funds in foreign countries. The Investment Company Institute ("ICI") has met regularly in recent years with its European counterpart, the European Federation of Investment Companies and Funds. These representatives are working to develop terms for a United States-European Community treaty to facilitate cross-border sales, which the industries propose to present to their respective governments. The topic of cross-border sales of investment company shares also is frequently raised in meetings between the Commission and foreign officials.

There are a number of barriers to cross-border sales of United States investment company shares. For example, to capitalize on the significant investment required in order to reach a large market abroad, United States funds must be able to comply simultaneously with different rules in several countries. In some foreign jurisdictions, United States funds may be subject to more restrictive conditions than are funds organized in those jurisdictions.<sup>11</sup> Perhaps most importantly, United States funds may find it difficult to break into well-established affiliated distribution networks.<sup>12</sup>

Obviously, only foreign jurisdictions can remove these barriers, but many argue that at least one principal problem for United States funds marketing abroad could be resolved unilaterally by the United States. United States tax law

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<sup>10</sup>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 UCITS Directive generally permits a Member State to impose more stringent requirements on its own UCITS than on other Member States' UCITS sold within its borders.

<sup>11</sup>For example, in Japan, a foreign investment trust fund may not denominate its securities in yen. See *infra* note 68 and accompanying text. In Germany, foreign funds are subject to higher fees and more complex notification procedures than domestic funds or UCITS. Roland W. Baum and Olivia P. Adler, *Public Distribution of Foreign Mutual Fund Shares in Germany*, 23 REV. SEC. & COMMODITIES REG. 223, 225 (1990).

<sup>12</sup>Generally, large investment company complexes with the ability to absorb temporary losses sustained while developing a foreign distribution network cite time, money, and unfavorable United States tax treatment as the primary obstacles, not foreign law. These complexes tend to be less eager than others about changes in regulation to facilitate cross-border sales. Investment company complexes, typically smaller, that do not now operate overseas generally express more enthusiasm about regulatory reform, believing that amending our laws to provide foreign investment companies greater access in the United States will facilitate improved market access for them in other countries.

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deters foreign investors from purchasing securities issued by United States investment companies.<sup>13</sup> Unlike the United States, many foreign countries do not impose distribution and withholding requirements on investment company income.<sup>14</sup> They also tend to impose little if any capital gains tax. These distinctions encourage foreign investors to purchase securities from non-United States investment companies.

From the perspective of a foreign fund seeking to market its securities in the United States, the Investment Company Act<sup>15</sup> presents a formidable challenge. Section 7(d)<sup>16</sup> prohibits a foreign investment company from making a public offering of its shares in the United States through United States jurisdictional means unless the Commission issues an order permitting it to register under the Investment Company Act. Under that section, the Commission must find that "by reason of special circumstances or arrangements, it is both legally and practically feasible effectively to enforce the provisions of [the Act] against such company and that the issuance of such order is otherwise consistent with the public interest and the protection of investors."

Congress enacted section 7(d) to enable the Commission to enforce the investor protections of the Investment Company Act against foreign funds operating in the United States.<sup>17</sup> Section 7(d) was intended to ensure the integrity of the United States investment company industry, and effectively provides national treatment for foreign funds registering in the United States. Unfortunately, because foreign regulatory systems for investment companies differ greatly from the Investment Company Act, section 7(d) has operated to limit the entry of foreign funds into the United States market. Because the standard effectively requires a foreign investment company organized in a country with substantially different investment company regulation to structure itself and operate as a United States company, it has proved impossible for most foreign investment companies to meet. In fact, only nineteen foreign funds, most

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<sup>13</sup>See, e.g., Letter from The Equitable Life Assurance Society of the United States to Jonathan G. Katz, Secretary, SEC 31 (Oct. 5, 1990), File No. S7-11-90; Letter from Federated Investors to Jonathan G. Katz, Secretary, SEC (Oct. 10, 1990), File No. S7-11-90; and Letter from IDS Financial Services, Inc. to Jonathan G. Katz, Secretary, SEC 28 (Oct. 2, 1990), File No. S7-11-90.

<sup>14</sup>See *infra* Section IV.A.

<sup>15</sup>Investment Company Act of 1940, 15 U.S.C. § 80a.

<sup>16</sup>15 U.S.C. § 80a-7(d).

<sup>17</sup>See Commission Policy and Guidelines for Filing of Application for Order Permitting Registration under the Act and Sale of Shares in the United States of Foreign Investment Companies, Investment Company Act Release No. 8959 (Sept. 26, 1975), 40 FR 45424, discussed *infra* notes 26-31 and accompanying text.

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from Canada, have ever received orders under section 7(d). The last such order was issued in 1973.<sup>18</sup>

Faced with this standard, a foreign investment company may decide to avoid section 7(d) registration requirements by making only a limited United States offering. The Commission has stated that section 7(d) permits a foreign investment company to make a private offering of its securities in the United States without registering, provided that the company has no more than 100 beneficial owners who are United States residents.<sup>19</sup> Because a foreign investment company may fear the consequences of inadvertently failing to stay within the numerical limit, it might not consider this approach to be a realistic alternative.

A foreign investment company that receives a Commission order under section 7(d) must satisfy another layer of securities regulation in the United States, the "blue sky" laws of those states in which it seeks to offer its securities. Some critics question the merits of state blue sky substantive investment company regulation, considering that the company already would be subject to the extensive investor protections of the Investment Company Act, as well as to its home country investment company regulation.

In view of the opportunities for both United States investors and investment companies if hurdles to cross-border sales are lowered, the Division recommends that the Commission adopt a multi-faceted approach to remove unnecessary barriers to cross-border sales of investment company securities. To promote greater access to foreign markets by United States funds, we recommend that the Commission expand current consultations with foreign fund regulators to increase mutual understanding of investment company regulatory systems. To facilitate access to United States markets by foreign funds and to foreign markets by United States funds, we recommend that section 7(d) of the Investment Company Act be amended to authorize the Commission to enter into bilateral regulatory memoranda of understanding that would create a framework for regulatory cooperation and mutual recognition of investment company regulation. We propose that section 7(d) further be amended to give the Commission greater flexibility to permit foreign funds to register in the United States and to clarify, in the absence of a public offering, when section 7(d) requires foreign funds to register.

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<sup>18</sup>See Pan Australian Fund Limited, Investment Company Act Release Nos. 7795 (Apr. 30, 1973), 38 FR 11141 (Notice of Application) and 8028 (Oct. 10, 1973), 2 SEC Docket 585 (Order).

<sup>19</sup>See Resale of Restricted Securities; Changes to Method of Determining Holding Period of Restricted Securities under Rules 144 and 145, Securities Act Release No. 6862, at II.F (Apr. 23, 1990), 55 FR 17933, 17940-41.

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The Division also recommends that the Commission continue to work with state securities regulators to coordinate and consolidate substantive regulation while preserving states' significant enforcement responsibilities. Finally, the Division recommends that the competitive disadvantages for United States funds created by the Internal Revenue Code be addressed, although we express no view on specific terms of any amendments to the Code.

This chapter begins with an historical overview of commission attempts to provide a workable standard under section 7(d) for public and private offerings by foreign investment companies. Then follows an explanation of the Division's recommendation to amend section 7(d) to facilitate cross-border sales of investment company securities, maintain investor protection standards, and encourage foreign regulators to provide and facilitate meaningful market access by United States investment companies. The chapter ends with a recommendation that the Commission support generally tax proposals that would enable United States investment companies securing access to foreign markets to compete effectively with foreign funds, and that the Commission continue to work with state securities administrators to eliminate duplicative substantive regulation of investment companies.

## **II. Background -- Commission Experience with Section 7(d)**

The initial Senate version of what became the Investment Company Act absolutely prohibited foreign investment companies from publicly offering their securities in the United States.<sup>20</sup> Ultimately, Congress determined that it would be inappropriate to exclude a foreign investment company from United States markets if the Investment Company Act could be enforced against the company and registration would not adversely affect the public interest or investor protection. It enacted a redrafted version of the section, incorporating strict enforceability and public interest provisions.<sup>21</sup>

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<sup>20</sup>*Investment Trusts and Investment Companies: Hearings on S. 3580 Before a Subcomm. of the Senate Comm. on Banking and Currency*, 76th Cong., 3d Sess. 6 (1940) [hereinafter 1940 Senate Hearings].

<sup>21</sup>Section 7(d) provides:

No investment company, unless organized or otherwise created under the laws of the United States or of a State, and no depositor or trustee of or underwriter for such a company not so organized or created, shall make use of the mails or any means or instrumentality of interstate commerce, directly or indirectly, to offer for sale, sell, or deliver after sale, in connection with a public offering, any security of which such company is the issuer. Notwithstanding the provisions of this subsection and of Section 8(a), the Commission is authorized, upon application by an investment company organized or otherwise created under the laws of a foreign country, to issue a conditional or unconditional order permitting  
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For the past fifty years, the enforceability standard of section 7(d) has precluded all but a few foreign investment companies from making public offerings in the United States. Section 7(d) theoretically permits foreign funds to register, but practically prevents them from doing so. The Commission has made several unsuccessful attempts to resolve this dilemma.

#### A. Early Canadian Applications and Rule 7d-1

In the early 1950's, four Canadian investment companies applied to the Commission for section 7(d) orders. In reviewing these applications, the Commission considered the circumstances under which the Investment Company Act would apply to the persons or transactions involved and the ability of the Commission and investors effectively to enforce the Act.

In 1954, the Commission adopted rule 7d-1, setting forth the conditions with which Canadian applicants must comply to satisfy the enforceability standard of section 7(d).<sup>21</sup> Among other criteria, the rule requires that:..

- (1)the fund's charter and bylaws contain the substantive provisions of the Investment Company Act, and an interpretation of the charter or bylaws conform with United States law;
- (2) each officer, director, adviser, custodian, and underwriter for the investment company enter into an agreement, filed with the Commission, that provides that each will comply with the Investment Company Act, and that the shareholders of the investment company may sue in the United States for any violation of the Investment Company Act;
- (3) at least a majority of the directors and officers be United States citizens, a majority of whom will be United States residents;

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<sup>21</sup>(...continued)

such company to register under this title and to make a public offering of its securities by use of the mails and means or instrumentalities of interstate commerce, if the Commission finds that, by reason of special circumstances or arrangements, it is both legally and practically feasible effectively to enforce the provisions of this title against such company and that the issuance of such order is otherwise consistent with the public interest and the protection of investors.

<sup>22</sup>17 C.F.R. § 270.7d-1; Notice of Proposed Rule N-7D-1 Relating to Registration of Management Investment Companies Organized under Canadian Law, Investment Company Act Release No. 1945 (Jan. 28, 1954), 19 FR 754 (proposing rule 7d-1); and Adoption of Rule N-7D-1 Relating to Registration of Management Investment Companies Organized under Canadian Law, Investment Company Act Release No. 1973 (Apr. 27, 1954), 19 FR 2584 (adopting rule 7d-1).

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- (4) all of the investment company's assets be maintained in the United States with a United States bank;
  - (5) the original or a duplicate copy of the investment company's books and records be kept in the United States;
  - (6) the investment company's principal underwriter be a United States entity; and
  - (7) the investment company use a United States auditor.

Although the rule by its terms applies only to Canadian companies, the Commission also requires non-Canadian foreign investment companies seeking registration orders to comply with the rule's conditions.<sup>23</sup> Because the conditions dictate that a company relying on the rule be structured and operated in large part like a United States investment company, they are impractical for most foreign investment companies.

## **B. Foreign Portfolio Sales Corporation Act of 1973**

In 1973, the Commission proposed amendments to the Investment Company Act to provide special provisions for the registration and regulation of domestic investment companies organized to sell their securities exclusively to foreigners, and to give the Commission greater flexibility to permit foreign investment companies to register under the Act.<sup>24</sup> While the proposal would

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<sup>23</sup>Between 1954 and 1973, the Commission issued section 7(d) orders to investment companies from Canada, Australia, Bermuda, South Africa, and the United Kingdom. Of these, only three Canadian funds and the one South African fund remain active. Each of the applicants agreed to comply with the conditions in rule 7d-1 as a prerequisite to receiving its section 7(d) order.

In some instances, the Commission has granted limited exemptive relief from rule 7d-1. For example, in 1979, the Commission permitted a Canadian investment company to maintain its Japanese portfolio securities in the custody of a Japanese branch of a United States bank, which otherwise violated rule 7d-1(b)(8)(v) (providing, among other things, that the company's trustee must maintain sole custody of all of the company's securities and cash in the United States.) See Templeton Growth Fund, Ltd., Investment Company Act Release Nos. 10628 (Mar. 13, 1979), 44 FR 17247 (Notice of Application) and 10657 (Apr. 11, 1979), 17 SEC Docket 280 (Order).

<sup>24</sup>H.R. 8256, 93d Cong., 1st Sess. (1973). The proposal would have provided for the registration of a new type of investment company that would sell its securities exclusively to foreign investors. The Commission anticipated that the legislation would be accompanied by changes in United States tax law to provide a United States fund that sold exclusively to foreign investors with tax treatment comparable to that available to offshore funds investing in United States securities. This tax treatment would have encouraged offshore funds investing in securities of United States issuers to consider domiciling in the United States. See also Offshore Fund (continued...)

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have continued to require a Commission determination that it was "both legally and practically feasible effectively to enforce" the provisions of the Investment Company Act against a foreign fund, it also would have authorized the Commission to "take into account the differing laws, regulations, customs, and business conditions of particular countries in which such companies are organized and the adequacy of existing regulation in such countries."<sup>25</sup>

The proposal was introduced in the House of Representatives, but no further action was taken. In retrospect, it seems probable that even had the amendment become law, it would not have improved the prospects for a foreign fund seeking a section 7(d) order, since it would have retained the strict enforceability language of section 7(d). More likely, the statute would have generated lengthy hearings comparing foreign law and United States law, and invited litigation on the enforceability of the Investment Company Act against a foreign fund.

### C. The 1975 Guidelines

In 1975, the Commission issued guidelines for foreign investment companies seeking to register in the United States.<sup>26</sup> The 1975 guidelines temper the requirements of rule 7d-1 by providing that foreign investment companies may satisfy the standards of section 7(d) through other means. Since "differences in foreign law applicable to a foreign investment company . . . might prevent compliance with all of the requirements of the [Investment Company] Act,"<sup>27</sup> the guidelines state that it may be appropriate for the Commission to grant relief under sections 7(d), 6(c),<sup>28</sup> or other sections of the Act. In reviewing registration applications by foreign investment companies, the Commission might "take into account the differing laws, regulations, customs and business conditions of particular countries in which such companies are organized and the adequacy of existing regulation in such countries."<sup>29</sup> The protections accorded investors by the regulatory system governing a foreign investment company, however,

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"(...continued)

**Legislation Proposed by the Securities and Exchange Commission, Investment Company Act Release No. 7751 (Apr. 3, 1973), [1973 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 79,306 (announcing the submission of the legislative proposal to Congress).**

<sup>25</sup>H.R. 8256, *supra* note 24.

<sup>26</sup>Inv. Co. Act Rel. 8959, *supra* note 17.

<sup>27</sup>*Id.* at 1.

<sup>28</sup>15 U.S.C. § 80a-6(c).

<sup>29</sup>Inv. Co. Act Rel. 8959, *supra* note 17, at 2.

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"should be substantially equivalent to those provisions of the [Investment Company] Act which the Commission determines should be applicable to the foreign investment company."<sup>30</sup>

The 1975 guidelines, in theory, afford the Commission greater flexibility in interpreting the enforceability standard of section 7(d).<sup>31</sup> The guidelines, however, have never resulted in a section 7(d) order.

#### **D. The Union-Investment Application**

The 1975 guidelines appear in practice to be flawed for much the same reason that the 1973 proposed legislation may have been flawed. Like the legislative proposal, they require the Commission to make detailed findings about the adequacy of foreign law in the narrow context of a specific application, rather than encouraging the Commission to consult directly with foreign regulators in the broader context of determinations on a country-by-country basis.

The Commission's protracted consideration during the 1970's and early 1980's of an application by Union-Investment Gesellschaft m.b.H. ("Union-Investment"), a West German investment management company, on behalf of Unifonds, a West German mutual fund, illustrates this point. The Union-Investment application requested a Commission order under section 6(c) granting exemptions from many provisions of the Investment Company Act, and under section 7(d) permitting registration of Union-Investment, so that it could sell Unifonds shares in the United States.

The Union-Investment application raised a number of novel and difficult issues. For example, Unifonds did not have the legal stature of an entity capable of applying to register under the Investment Company Act. Union-Investment applied on its behalf. In addition, German law prevented Unifonds from agreeing to basic jurisdictional requirements, including consent to jurisdiction of United States courts or appointment of an agent for service of process in the United

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<sup>30</sup>*Id.* at 1.

<sup>31</sup>The guidelines require that a foreign investment company applicant: (1)be a bona fide and established company; (2)be subject to actual regulation by an appropriate foreign governmental authority; (3) not be dependent solely on sales in the United States; (4)be a vehicle for investment primarily in foreign securities; (5)subject itself and its management to service of process; and (6) provide adequate disclosure to investors in the United States. A foreign investment company generally would satisfy these requirements by complying with standards outlined in the release, including that the investment company have minimum net assets of \$50 million, a minimum of 500 shareholders resident in the country in which it is organized, no more than 50% of its shares sold to United States investors, and a minimum of either 60% of the value of its portfolio invested in issuers in the country in which it is organized or 75% in non-United States issuers. ***Id.* at 2.**

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States.<sup>32</sup> Furthermore, Union-Investment was unable or unwilling to comply with the Investment Company Act in a number of significant respects (e.g., affiliated transactions, disinterested directors, and voting shareholders).

Nonetheless, the Commission published a notice of the application in 1982.<sup>33</sup> In 1983, after the ICI requested a hearing on the application,<sup>34</sup> Union-Investment announced that it could no longer bear the time and expense involved in continuing to pursue its registration and exemptive requests, and withdrew its application.

#### E. The "Mirror Funds" Release

The Union-Investment application demonstrated that, notwithstanding the 1975 guidelines, a foreign investment company still may have difficulty meeting section 7(d)'s enforceability standards. In December 1983, following Union-Investment's withdrawal, the Commission issued a release advising any prospective foreign investment company applicant subject to laws conflicting irreconcilably with the Investment Company Act to consider forming a "mirror" fund to offer its securities in the United States.<sup>35</sup> By organizing a United States

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<sup>32</sup>See, e.g., 17 C.F.R. § 270.7d-1(b)(1), (b)(2), (b)(2), (b)(6), (b)(8). Union-Investment had consented to United States jurisdiction and to the appointment of an agent for service of process in the United States. It also undertook to secure an irrevocable letter of credit, initially in the amount of \$1 million, to be increased to an amount equaling five percent of Unifonds shares actually sold in the United States, to be available to pay damages to any person obtaining a United States judgment against Union-Investment for violating United States securities laws.

These conditions, however, could not ensure the Commission's ability to investigate possible cases of United States securities law violations or to bring a criminal action or enforce an injunction against Unifonds, its distributor, custodian, or accountant, or against the officers of Union-Investment. Union-Investment represented that it would have been inconsistent with West German business practices for these parties to have agreed to comply with the terms of the Investment Company Act, waive their immunity from personal liability to United States shareholders, consent to jurisdiction of United States courts, and appoint an agent for service of process in the United States. Moreover, neither Unifonds nor Union-Investment would have maintained duplicate books or records in the United States, and German law prohibited Union-Investment from permitting Commission staff to inspect books and records in Germany.

<sup>33</sup>Union-Investment-Gesellschaft m.b.H., Investment Company Act Release No. 12863 (Dec. 1, 1982), 47 FR 57179 (Notice of Application).

<sup>34</sup>Union-Investment-Gesellschaft m.b.H.; Hearing on Application for an Order Permitting Registration of an Investment Company Organized in West Germany and Granting Exemptions, Investment Company Act Release No. 13234A (May 17, 1983), 48 FR 23342.

<sup>35</sup>Applications of Foreign Investment Companies Filed Pursuant to Section 7(d) of the Investment Company Act of 1940, Investment Company Act Release No. 13691 (Dec. 23, 1983), 49 FR 55.

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investment company investing primarily in the securities of foreign issuers, a foreign money manager would be able to offer its services to United States investors without needing to register the foreign investment company under section 7(d).<sup>36</sup> The newly-created United States fund could "mirror" the investments of any of the foreign money manager's foreign funds. The Commission emphasized that this approach was not based on the merits of foreign regulatory systems as compared to the United States system, but rather on the reality that, unless section 7(d) was amended, a mirror fund was a more feasible and less costly alternative to registration.<sup>37</sup>

The mirror fund alternative has the advantage of avoiding section 7(d) determinations about the adequacy of foreign law and investor protection under that law. Judging from the registration of foreign-based advisers and subadvisers, mirror funds may comprise a significant portion of the growing number of United States companies investing in foreign securities.<sup>38</sup>

The mirror fund approach, however, is of limited practicality in an increasingly international securities market. It is a burdensome and expensive option for foreign investment companies. As a separate company, a mirror fund loses the ability to promote its securities in the United States based on any previous successful history of the overseas investment company,<sup>39</sup> and cannot realize certain economies of scale. The investing public ultimately bears the additional costs. The mirror fund solution does little to improve United States investment company access abroad.

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<sup>36</sup>Of course, the "mirror" fund would need to register under section 8 of the Investment Company Act (**15 U.S.C. § 80a-8**).

<sup>37</sup>Inv. Co. Act. Rel. **13691**, *supra* note 35.

<sup>38</sup>As of September **1988**, **165** foreign investment advisers representing **27** countries had registered in the United States; by March **1992**, **269** foreign advisers representing **36** countries had registered. A significant number of the United States registered investment companies advised by these foreign advisers may be mirror funds. See, e.g., The Japan OTC Equity Fund, Inc. (Registration No. **811-5992**), advised by Nomura Investment Management; The Germany Fund (Registration No. **811-4632**), advised by DB Capital Management International (Deutsche Bank); and The First Australia Fund (Registration No. **811-4438**), advised by EquitiLink Australia Ltd.

<sup>39</sup>See **17 C.F.R. § 230.482(e)**; Advertising by Investment Companies, Investment Company Act Release No. **16245** at n.**31** (Feb. 2, 1988), **53 FR 3868** (adopting advertising rules).

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## F. The Foreign Investment Company Amendments Act of 1984

One month after issuing the mirror funds release, the Commission proposed the Foreign Investment Company Act Amendments of 1984.<sup>40</sup> The Commission observed that section 7(d) had operated to prevent foreign investment companies from registering under the Investment Company Act and offering shares in the United States, which, in turn, led to "needless costs and insurmountable barriers to foreign companies seeking access to United States markets, lost competitive opportunities, and a denial of investment opportunities for United States investors."<sup>41</sup> The proposed legislation would have given the Commission greater flexibility to recognize differences among regulatory systems and "to fashion workable regulatory approaches for companies doing business internationally without sacrificing investor protection."<sup>42</sup>

The proposal would have retained the present language of section 7(d), but also would have authorized the Commission to exempt an operating foreign investment company from any provision of the Investment Company Act, provided that: (1) compliance with the provision would be unduly burdensome because the company was organized or otherwise created under foreign law and invested primarily in foreign securities; (2) either the laws under which the company operated provided protections for investors that served the same purposes as the protections provided by the provisions of the Investment Company Act from which exemption was requested, or specific conditions agreed to by the company provided such protections; (3) an exemption was consistent with the protection of investors and the purposes fairly intended by the policies of the Investment Company Act; and (4) the company was not operated for the purpose of evading the provisions of the Investment Company Act. By broadening the Commission's authority to grant exemptions, the proposal would have relaxed significantly the enforceability standard of section 7(d).

The proposal included a number of important safeguards. It would have applied only to operating foreign investment companies. An operating foreign investment company was defined as a company, organized or created under the laws of a foreign country, that had been in operation with a minimum of 500 non-United States shareholders and \$100 million in net assets for at least three years,

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<sup>40</sup>Letter from John S.R. Shad, Chairman, United States Securities and Exchange Commission, to Thomas P. O'Neill, Jr., Speaker of the United States House of Representatives (Jan. 31, 1984) (transmitting proposal to amend section 7(d)).

<sup>41</sup>Memorandum of the Securities and Exchange Commission in Support of the Foreign Investment Company Amendments Act of 1984, at 1 (Jan. 31, 1984) (accompanying proposal to amend section 7(d)).

<sup>42</sup>*Id.* at 3.

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and that was primarily engaged in investing in the securities of non-United States issuers.<sup>43</sup> This requirement was intended to deter United States investment company sponsors from moving offshore to a jurisdiction with differing regulation and seeking a section 7(d) order.<sup>44</sup>

The Commission's proposal never was introduced in Congress. Critics argue that it would have offered foreign investment companies a competitive advantage in the United States. They maintain that for many foreign investment companies, the costs of complying with the laws of their home countries are lower than those incurred by United States investment companies complying with United States securities laws.<sup>45</sup> They also charge that the proposal did not address the barriers that United States investment companies face when offering their shares abroad. Arguing that foreign laws imposing stricter licensing and other requirements on non-domestic investment companies have greatly limited the marketing of United States investment company shares overseas, industry representatives generally favor amendments that would permit the Commission to consider reciprocity as a factor in determining whether to issue an order permitting registration of a foreign fund.<sup>46</sup>

Furthermore, the 1984 proposal again would have required the Commission to make difficult determinations about the adequacy of foreign law compared with United States law in the context of a specific application. In addition to the problems identified in the course of the Union-Investment application, gaps between foreign law as written and as practiced would make it difficult for the Commission to make these findings. Moreover, making these determinations in the context of individual applications could result in inappropriate precedent. Given variations in size, reputation, practice, and success among foreign investment companies from the same country, the process

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<sup>43</sup>*Id.* at 5. Foreign funds that did not meet the definition would have remained subject to the original section 7(d) standards.

<sup>44</sup>The proposal also provided that any section 7(d) order could be revoked or modified if the circumstances upon which the order were based had changed. This could occur, for example, if the applicable provisions of the Investment Company Act could no longer be enforced against the company, the regulatory system upon which the Commission's determination was based no longer provided sufficient investor protections, or if the foreign company no longer was engaged primarily in investing in securities of non-United States issuers. *Id.*

<sup>45</sup>See Letter from Davis, Polk & Wardwell to Jonathan G. Katz, Secretary, SEC 20 (Oct. 10, 1990), File No. S7-11-90 (summarizing critics' objections) [hereinafter Davis Polk **Study Comment**].

<sup>46</sup>See *id.*; Letter from Investment Company Institute to Jonathan G. Katz, Secretary, SEC 65-66 (Oct. 5, 1990), File No. S7-11-90; and Letter from Prudential Mutual Fund Management, Inc. to Jonathan G. Katz, Secretary, SEC 8 (Oct. 9, 1990), File No. S7-11-90.

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could have resulted in the development of application standards that would have been unsuitable for other investment companies from even the same country.

### G. Section 7(d) and Private Offerings

Section 7(d) is the only section of the Act directed specifically to foreign investment companies. While section 7(d) prohibits a foreign fund from making a *public* offering of its securities in the United States without obtaining a Commission order permitting it to register under the Investment Company Act, it does not expressly prohibit private offerings or limit the number of shareholders that a foreign fund may have.<sup>47</sup>

Section 3(c)(1) of the Investment Company Act addresses offerings by private investment companies.<sup>48</sup> It excepts from the definition of investment company an entity that has no more than 100 beneficial owners of its securities and that does not presently propose to make a public offering of its securities. As discussed in Chapter 2, Congress determined that the point at which an investment company has more than 100 owners reasonably reflects when public interest concerns arise.

If an entity does not qualify for the section 3(c)(1) exception and is otherwise an investment company as defined in the Act, it must look to section 7 for its registration obligation. Section 7(a) prohibits a domestic fund from making any offering of its securities without Investment Company Act registration. In contrast, by its terms, section 7(d) only prohibits an unregistered foreign fund from making a *public* offering in the United States.

The Commission, through interpretation of the statute, has married section 7(d) to section 3(c)(1). In 1984, the Division stated that an unregistered foreign fund could make a private offering in the United States concurrently with a public offering abroad and not violate section 7(d), provided the fund had no

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<sup>47</sup>Congress, in the legislative history of section 7(d), did not distinguish between public and private offerings by foreign investment companies. See 1940 *Senate Hearings*, *supra* note 20, at 196-97 (statement of David Schenker, Counsel for the Investment Trust Study, Securities and Exchange Commission); S. REP. No. 1775, 76th Cong., 3d Sess. 13 (1940).

<sup>48</sup>15 U.S.C. § 80a-3(c)(1).

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more than 100 beneficial owners resident in the United States.<sup>49</sup> In 1990, the Commission endorsed that position in its release adopting rule 144A.<sup>50</sup>

Critics of the Commission's position charge that it lacks a statutory basis. They argue that Congress intended section 7(d) to restrict only *public* offerings by foreign investment companies, and stress that section 7(d) does not contain any shareholder limit comparable to that found in section 3(c)(1). They also point out that the Commission's position creates competitive problems for foreign funds.<sup>51</sup>

For example, certain foreign central depository systems like Euro-Clear and CEDEL (Central de Livraison Valeurs Mobilières) do not provide for constant monitoring of the nationalities of purchasers. Consequently, the Commission's position compels foreign funds considering United States offerings to include charter provisions permitting forced transfers, purchases, or denials of ownership registration whenever the number of United States residential owners exceeds 100. These procedures are quite costly and burdensome.<sup>52</sup> Further, because it is difficult to track ownership of United States residents, foreign funds may inadvertently exceed the 100 United States resident limit. Fear of inadvertent

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<sup>49</sup>Touche Remnant (pub. avail. Aug. 27, 1984). The position that the private offering need not be integrated with the public offering is consistent with Regulation D under the Securities Act of 1933 (17 C.F.R. §§ 230.501 - .508 (1991)). Preliminary Note 7 to Regulation D states that an issuer may make a private placement in the United States in accordance with Regulation D concurrently with an offering abroad in accordance with Regulation S under the Securities Act (17 C.F.R. §§ 230.901 - .904) without integrating the two offerings.

<sup>50</sup>The release stated:

The Commission believes that resales of privately placed investment company securities pursuant to the safe harbor provisions of Rule 144A would not cause the issuing investment company to lose the exemption provided by section 3(c)(1) or **cause a violation** of section 7(d) of the Investment Company Act as long as after the resale the securities are held, for purposes of section 3(c)(1), by no more than 100 beneficial owners or, for purposes of section 7(d), by no more than 100 beneficial owners who are U.S. residents . . . . Rule 144A will not obviate the obligation of . . . a foreign investment company [ ] to apply for an exemptive order permitting it to register [ ] under the Investment Company Act if . . . there will be more than 100 U.S. residents who are beneficial owners of its securities.

Sec. Act Rel. 6862, *supra* note 19, at II.F.

<sup>51</sup>See, e.g., Letter from Cleary, Gottlieb, Steen & Hamilton to Jonathan G. Katz, Secretary, SEC 30 (Oct. 12, 1990), File No. S7-11-90.

<sup>52</sup>See, e.g., Davis Polk Study Comment, *supra* note 45, at 16-17.

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violations may cause foreign funds to forego completely offering their securities in the United States.

Section 7(d) is intended to protect United States investors by subjecting foreign and domestic investment companies to similar standards. The Commission's position does prevent foreign funds from circumventing the point at which a valid United States regulatory interest arises and from enjoying an unfair advantage over domestic funds. Therefore, the effects of the position plus the absence of language in section 7(d) specifically addressing non-public offerings by foreign investment companies warrant statutory clarification.

### **111. Discussion -- Removing Unnecessary Barriers to Cross-Border Sales**

The Division analyzed a number of approaches to overcoming the barriers created by section 7(d), including: more expansive use of the Commission's exemptive and rulemaking authority; harmonization of United States and foreign law; pursuit of treaties that would override section 7(d); and amending section 7(d) to give the Commission more flexibility in permitting foreign funds to register under the Investment Company Act.

The Commission has tried repeatedly to use its authority within the strictures of section 7(d). Further expanding the Commission's use of existing authority would disregard the strict limitations that section 7(d) places on the Commission's flexibility, as demonstrated by the history of the Union-Investment application, and, as such, is unworkable. Accordingly, we do not recommend it. Harmonization and treaty negotiations have merit, but, as discussed below, both approaches have significant drawbacks and are not substitutes for an amendment of section 7(d). Only the third approach, statutory amendment, promises both to offer greater access by United States funds to foreign markets and to maintain an effective and efficient means of regulation. Under our proposal, section 7(d) would be amended to provide the flexibility needed to permit foreign funds to register under the Investment Company Act and encourage foreign regulators to ease regulatory restrictions on United States funds abroad.

#### **A. Harmonization**

Harmonizing the provisions of the Investment Company Act with standards provided under foreign law<sup>53</sup> would assure equality of investor

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<sup>53</sup>"Harmonization" refers to the achievement of substantially identical regulatory regimes or common regulatory requirements. It should be distinguished from "mutual recognition," which means two or more jurisdictions have regulation following the same basic principles and each generally accepts compliance with the others' rules within its own jurisdiction.

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protection and the elimination of competitive disadvantages, provided each jurisdiction interpreted and enforced its laws similarly. The differences between the regulatory systems of foreign countries and the United States are so vast, however, that harmonization is unlikely in the foreseeable future.

Many foreign investment company regulatory systems are driven by fundamentally different philosophical underpinnings from those underlying the United States system. For example, Japan and many of the Member States in the European Community rely on licensing or authorization procedures to restrict market entrance to only "fit and proper" applicants. In contrast, in the United States, any person may sponsor an investment company provided it has the necessary seed money of \$100,000 and is not subject to a statutory disqualification. While some may view the vetting system as unduly paternalistic and subject to abuse and favoritism, foreign regulators may view the more open system of the United States as inordinately risky.

Further, many of the regulatory provisions that Congress and the Commission have deemed essential to investor protection simply do not exist abroad. For example, the European Community's UCITS Directive does not prohibit backward pricing of fund shares; United States regulation under the Investment Company Act requires forward pricing to avoid manipulative practices.<sup>54</sup> Similarly, most European Community Member States do not prohibit transactions between a fund and an affiliate; in the United States, the prohibition against affiliated transactions is a cornerstone of the Investment Company Act.<sup>55</sup> Such widespread differences among countries suggest that harmonization is unlikely in the foreseeable future.

Because complete harmonization is unlikely, some industry representatives have suggested a more limited approach. They propose an amendment of the Investment Company Act to authorize an alternate collective investment vehicle, the unitary investment fund ("UIF"). They argue that the UIF would be a new type of United States investment company that would resemble more closely the structure of investment companies in the European Community and Japan.

As discussed in Chapter 7, the Division has analyzed the UIF. We conclude that, while the governance requirements of the Investment Company Act may be improved, they are generally efficient and should not be replaced. In addition, the Division does not believe that the UIF would resolve section 7(d)

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<sup>54</sup>See Chapter 8.

<sup>55</sup>Many Member States apparently rely on an investment company's depositary to prevent abuses that may arise from affiliated transactions, even though the depositary is itself an affiliate of the investment company.

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issues. Despite the UIFs structural similarity to investment vehicles in other countries, it would not address the significant differences in regulatory approaches to other investor protection issues, such as the treatment of affiliated transactions and pricing methods.

## B. Treaties

Mutual recognition through treaties is another possible route for achieving cross-border sales of investment management services. The pursuit of treaties with other countries is the most obvious and often recommended mutual recognition approach. A treaty would supersede the current enforceability standard of section 7(d).

A treaty between two countries, such as the United States and Canada, for example, might provide that shares of investment companies from either country could be traded freely in the other country, subject to some general guidelines. For instance, the treaty might provide that the country of domicile would regulate the fund's structure and operations, while each country would regulate marketing within its borders (an approach taken by the UCITS Directive). Presumably, either country could include in the treaty any additional conditions it believed necessary in order to permit entry by a foreign fund.

In light of the UCITS Directive, many have suggested that the European Community should be the United States' first treaty partner. The UCITS Directive allows cross-border sales within the European Community of UCITS, which resemble United States open-end funds. The development of a European Community-wide market for UCITS has raised hopes for a United States-European Community treaty that would allow any UCITS qualified in a Member State to register in the United States, and would allow United States investment companies to register in one and market in all twelve of the Member States.

The United States and European investment company industries already have attempted to lay the groundwork for this type of treaty. In recent years, the Investment Company Institute has met with its European counterpart to discuss the possibility of a reciprocal agreement along these lines. Representatives of both groups have met with Division staff to discuss the possibility of an agreement.

The Division believes that treaty negotiations are a useful alternative and should not be discounted. One major advantage of the treaty approach is that it allows the United States to determine, based on investor protection standards, which country or group of countries would be appropriate treaty partners; only funds from those countries would be affected.

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The treaty alternative may not be the most effective approach, however, because it may not give the Commission as much flexibility as would a legislative amendment of section 7(d). Should the foreign operation or regulation of a foreign fund registered in the United States materially change, amending a treaty likely would be much more difficult than amending a Commission rule or order under a revised section 7(d).

### C. Recommendation -- Amendment of Section 7(d)

The third approach, and the one the Division recommends, is a modified version of the Commission's 1984 legislative proposal. That proposal would have authorized the Commission to grant, by rule or order, permission to an "operating foreign investment company" to register under the Investment Company Act and to exempt it from one or more of the provisions of the Act if the Commission found that: compliance with the Act would be unduly burdensome, given the nature of the company; either the laws under which the company operates provide protections to investors that serve the same purposes as the provisions of the Act from which exemption is requested, or that specific conditions agreed to by the company provide these protections; an exemption is consistent with investor protection and the policies of the Act; and the company is not operated for the purpose of evading the provisions of the Act.<sup>56</sup>

Our proposal introduces five changes to the 1984 standards.<sup>57</sup> Our proposal also would address activities of investment companies that have not made a public offering in the United States, but have taken active steps to promote the sale of their securities to United States residents. The proposed amendment to section 7(d) would require a foreign investment company to register if it uses United States jurisdictional means in connection with any United States offering of its securities and has more than 100 shareholders of record who are United States residents. Similarly, a foreign investment company would be subject to section 7(d) if it has taken steps to facilitate secondary market trading in its securities by, among other things, listing its shares on a securities exchange or having its shares quoted in an over-the-counter market in the United States, and has more than 100 shareholders of record who are United States residents.

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<sup>56</sup>See supra Section II.F.

<sup>57</sup>The full text of our proposal is set forth in Appendix 4-A which appears at the end of this chapter.

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## **1. Necessary or Appropriate**

The Division's proposal would substitute a "necessary or appropriate in the public interest" standard for the 1984 proposal's "unduly burdensome" determination. This change would make the proposed language consistent with the standard of section 6(c).<sup>58</sup> Arguably, an "unduly burdensome" standard is a lower standard than domestic investment companies must meet in order to receive an exemption from a provision of the Investment Company Act. Domestic funds must demonstrate a requested exemption is necessary and appropriate in the public interest; the 1984 proposal would have required foreign funds to demonstrate that compliance would be merely too onerous.

## **2. Adequacy of Foreign Law -- Mutual Recognition**

Like the 1984 proposal, the Division's proposal would require the Commission to find that the foreign law under which a fund operates or specific conditions agreed to by the applicant provide protections for investors that serve the same purposes as the protections under provisions of the Investment Company Act from which the fund requests exemption. Of course, the protections provided by the foreign regulatory system need not be identical to the Investment Company Act provisions from which exemption is requested. Rather, the Commission need find that the foreign law adequately addresses the same regulatory concerns and serves essentially the same purposes, and that the exemption is consistent with the protection of investors and the purposes fairly intended by the Investment Company Act. In making that finding, the Commission could consider the different regulatory requirements, customs, investment company business practices, and overall investment company regulatory framework in the jurisdiction in which the fund is organized.<sup>59</sup>

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<sup>58</sup>Under section 6(c), the Commission must find that a proposed exemption is "necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of this title."

<sup>59</sup>For example, some foreign regulatory systems permit backward pricing and affiliated transactions. See *supra* notes 54-55 and accompanying text. Although prohibitions against backward pricing and certain affiliated transactions are cornerstones of the Investment Company Act, the Commission might determine that other protections afforded by those systems appropriately could substitute for the Act's prohibitions. Although we would not expect that the Commission would deny a request for a section 7(d) order merely because a regulatory system permitted affiliated transactions, it **would** be critical for the Commission to determine that the system protected fund investors against harm from such transactions. For instance, in the case of foreign funds operating under the UCITS Directive, the Commission might look at whether customary business practices in the European Community and monitoring by the depositary could serve the same purposes as provisions under section 17.

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The Division anticipates that it will be difficult to make detailed findings about the adequacy of foreign law, particularly if there exists a gap between the law as written and as actually practiced. To address this concern, the Division's proposal would require the Commission, prior to acting on applications for section 7(d) orders, to enter into bilateral regulatory memoranda of understanding with the securities authorities in countries with regulatory regimes providing the same type and quality of investor protection as provided by the Investment Company Act. The memorandum would set forth representations about the nature and extent of foreign regulation. Negotiating special memoranda of understanding with the appropriate foreign regulators would give the Commission the advantage of learning from the foreign regulators, rather than the applicants, the manner in which foreign law is interpreted and enforced, and would eliminate the need for extensive discussions with the applicants about how they are regulated!<sup>60</sup>

In addition, the memoranda would create a framework for regulatory cooperation and mutual recognition of investment company regulatory practices. They would establish the basis not only for exempting a foreign investment company from regulation under the Investment Company Act, but also for allowing United States funds to satisfy foreign regulatory requirements to the degree necessary to provide them complementary access into foreign countries!<sup>61</sup>

One of the principal criticisms of the 1984 proposal is that it failed to address barriers that United States companies face when offering shares abroad. Although investment company laws in some of the largest investment company markets outside the United States -- the United Kingdom, Germany, and Japan -- currently permit foreign investment companies to make public offerings of securities within their borders, differing legal standards and onerous regulatory requirements continue to make foreign registration problematic, if not impossible, for many United States investment companies.

For example, in the United Kingdom, United States investment companies face problems not unlike those created by section 7(d) for foreign funds. Section 87 of the Financial Services Act provides for registration of foreign investment companies from a country whose laws will protect investors in the United

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<sup>60</sup>Memoranda of understanding also would assist the Commission in reviewing the operations of United States investment companies registered and operating abroad. Agreements could help the Commission better understand foreign regulation of United States funds.

<sup>61</sup>Cf. H.R. 1347, 102d Cong., 1st Sess. (1991); S. 347, 102d Cong., 1st Sess. (1991) (as passed by the Senate) (a recent legislative initiative that would authorize the Commission to deny broker-dealer and investment adviser registration to a foreign company if the company's home country denies United States broker-dealers and investment advisers national treatment). The Commission took no position on this initiative.

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Kingdom at least to the extent to which investors are protected in authorized United Kingdom trusts.<sup>62</sup> The Isle of Man, Jersey, Guernsey, and Bermuda have been able to meet the standards in section 87; however, each jurisdiction changed its laws to make them nearly identical to those of the United Kingdom. Investment companies from the United States likely would have difficulty qualifying under section 87.<sup>63</sup>

United States investment companies more readily qualify to register under the statutes and regulations of countries such as Germany and Japan. In these countries, however, marketing and procedural hurdles restrict access by United States funds to foreign investors.

German law generally accommodates foreign investment companies not comporting with typical German investment company structures or relationships.<sup>64</sup> A United States investment company still may have difficulty breaking into the German investment company distribution network, however, because German banking and insurance companies marketing their own investment company securities dominate the market.<sup>65</sup>

Application of Japanese regulations appears to reduce the competitive ability of United States investment companies in other ways. United States and other foreign open-end investment trust funds may offer shares publicly if they meet the requirements of the "Standard Rules for the Selection of Foreign Investment Trust Funds to be Sold in Japan" of the Japan Securities Dealers

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<sup>62</sup>Financial Services Act, 1986, Ch. 8, § 87 (Eng.).

<sup>63</sup>Section 88, the other applicable provision in the Financial Services Act, is also problematic since that provision requires, among other things, that persons connected with the control and operation of the investment company be "fit and proper." *Id.* at Ch. 8, § 88. The Investment Company Act does not have a similar standard.

<sup>64</sup>For example, custodians of foreign investment companies need not perform exactly as custodians for German funds if investors are assured of security comparable to that provided under German domestic investment company law. Baum and Adler, *supra* note 11, at 227.

<sup>65</sup>*Id.* at 228. A few United States investment company complexes, including Pioneer and Templeton, have succeeded in developing distribution networks in Germany. As of July 1990, Pioneer had annual sales of \$150 million of its United States funds in West Germany. *Pioneer to Skip UCIT Route and Sell Own Funds in Europe*, FUND ACTION, July 9, 1990, at 7. Apparently, the United States tax treaty with Germany (reducing the withholding tax rate from 30% to 15%) and the credit Germany allows for payment of the United States withholding tax sufficiently reduce the United States tax burden for German investors.

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Association.<sup>66</sup> While these rules may seem relatively easy for United States and other foreign investment companies to satisfy, United States industry representatives state that **other** Japanese regulations severely impede United States market access and success.<sup>67</sup> For example, they prohibit United States and other foreign investment companies from denominating their securities in yen, and Japanese investors are generally reluctant to invest in foreign currency-denominated funds.<sup>68</sup> They also prohibit direct marketing of foreign fund shares, making it difficult for foreign government securities funds to develop a sales network for their products.

These types of market constraints led the opponents of the 1984 proposal to argue that foreign funds should not be allowed to register in the United States unless United States funds receive reciprocal treatment abroad. The Division believes that the memorandum of understanding approach to mutual recognition meets these concerns because, by resolving prudential and jurisdictional issues, the memoranda themselves would provide a mandate for bilateral access to each country's market.

In addition, a memorandum of understanding procedure would be a practical means of addressing compliance and enforcement issues. Under the Division's proposal, exemptions from the Investment Company Act for foreign funds will be based on a determination that the applicable foreign law is an adequate substitute. Accordingly, the appropriate foreign regulator in each case would be in the best position to assess compliance concerns under its own law. Following a memorandum of understanding procedure, the Commission would

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<sup>66</sup>THE INVESTMENT TRUSTS ASSOCIATION, INVESTMENT TRUSTS IN JAPAN 52 (1990). The Investment Trusts Association is the only authorized self-regulatory body of investment trust funds in Japan.

<sup>67</sup>Foreign investment managers have found it very difficult to secure licenses to manage investment trust funds in Japan. Until December 1989, Japanese law absolutely prohibited foreign firms from engaging in investment trust management in Japan. Today, although it may receive a license, a foreign management company must satisfy burdensome standards regarding capital, distribution, and administration. For example, Fidelity Investments, the only United States company that has received a license to manage a yen-denominated fund for Japanese investors, has not yet begun operations. Fidelity cites several reasons for the delay, including a capital requirement of \$7 to \$8 million to manage the fund, the need for an additional license to distribute fund shares (entailing another large capital contribution), and a requirement that foreign fund managers utilize 30 Japanese employees to support back office operations. Letter from Robert C. Pozen, General Counsel, Fidelity Investments, to Marianne Smythe, Director, Division of Investment Management, SEC (June 7, 1991) (expressing concerns about improving access by foreign investment companies to United States markets without simultaneously securing greater access for United States investment companies abroad).

<sup>68</sup>Managing Money: A Legal Guide to the World's Investment Fund Markets, INT'L FIN. L. REV. 109 (Special Supp. Apr. 1990).

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agree with foreign regulators as to how to enforce investor protections.<sup>69</sup> In an extreme case where foreign or United States methods of enforcement would prove inadequate, the Commission would have authority to revoke the registration order of the foreign fund. To the extent foreign regulators are unable to address a violation in the first instance, memoranda of understanding would provide mutually acceptable standards for cooperative enforcement efforts.<sup>70</sup>

The Division's proposal would increase the Commission's flexibility by expressly authorizing it to issue rules as well as orders in connection with registering operating foreign investment companies. In contrast to registration and exemptive orders, rulemaking would permit the Commission to take advantage of a country-by-country approach. Once the Commission negotiates a regulatory memorandum recognizing that a particular jurisdiction's regulatory system sufficiently protects fund investors and creating a framework for regulatory cooperation and mutual recognition of investment company regulation, a Commission rule would enable any investment company regulated under that system and complying with the terms of the rule to register under section 7(d).

### **3. Operating Foreign Investment Company**

The amendment, like the 1984 proposal, also would allow the Commission to deny a request for an order by an investment company seeking to circumvent the Investment Company Act. Obviously, an amended section 7(d) should not provide a means of access to United States investors by newly created foreign shell investment companies, or an incentive for United States funds to reorganize in a jurisdiction with more permissive regulation and receive section 7(d) orders permitting public offerings in the United States. By limiting section 7(d) orders to funds qualifying as "operating foreign investment companies," and requiring that an applicant not be operated for the purposes of evading the provisions of the Investment Company Act, the Commission in the 1984 proposal intended that only a *bona fide* foreign investment company with an established operating history could avail itself of the more flexible section 7(d) provisions. The 1984 proposal

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<sup>69</sup>Relying on memoranda of understanding is conceptually consistent with the Division's premise for amending section 7(d); namely, that the Commission may rely upon foreign regulation to provide protections serving the same purposes as those afforded under the Investment Company Act. If the Commission determines it may rely on foreign law in place of Investment Company Act requirements, it must also determine that the foreign law and regulators provide means for United States investors and the Commission to enforce foreign law. Memoranda of understanding could permit the Commission to determine whether United States investors in practice would have meaningful access to remedies under foreign law and the extent to which the Commission appropriately should require consent to United States jurisdiction and to the appointment of an agent for service of process.

<sup>70</sup>In no case should the proposed memoranda of understanding process affect the Commission's ability to enforce the fraud-related provisions of United States securities laws.

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would have defined an operating foreign investment company as a company that: (1) was organized or created under the laws of a foreign country; (2) had been in operation, with a minimum of 500 non-United States shareholders and \$100 million in net assets, for a period of three years or more; and (3) was primarily engaged in investing in the securities of non-United States issuers.

The Division recommends retaining the 1984 definition, with one important modification. To give the Commission necessary flexibility, the legislation should authorize the Commission to establish, by rule or order, the minimum assets under management, number of non-United States shareholders, and years in operation.<sup>71</sup>

#### **4. Commission Authority to Rescind Section 7(d) Orders**

The 1984 proposal would have authorized the Commission to rescind a section 7(d) order under circumstances suggesting that the order was not serving its intended purpose.<sup>72</sup> The Division's proposal deletes this authorization

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<sup>71</sup>The Division considered whether it might be more appropriate to use the analogous definitions of "foreign issuer" or "foreign private issuer" in rules and regulations under the Securities Act (15 U.S.C. §§ 77a-77aa) and the Securities Exchange Act (15 U.S.C. §§ 78a-78ll). Under the Exchange Act, "[t]he term 'foreign issuer' means any issuer which is a foreign government, a national of any foreign country or a corporation or other organization incorporated or organized under the laws of any foreign country." 17 C.F.R. § 240.3b-4(b); see also 17 C.F.R. § 230.902(f) (definition of "foreign issuer" under Regulation S of the Securities Act). "Foreign private issuer" under both acts

means any foreign issuer other than a foreign government except an issuer meeting the following conditions: (1) more than 50 percent of the outstanding voting securities of such issuer are held of record either directly or through voting trust certificates or depositary receipts by residents of the United States; and (2) any of the following: (i) the majority of the executive officers or directors are United States citizens or residents; (ii) more than 50 percent of the assets of the issuer are located in the United States; or (iii) the business of the issuer is administered principally in the United States.

17 C.F.R. §§ 230.405 and 240.3b-4(c). These definitions are intended to prevent foreign issuers generally owned and managed by United States persons from taking advantage of exemptions or forms available to other issuers organized under foreign law.

None of these definitions includes tests for minimum asset levels, number of non-United States shareholders, or operating history. As such, they do not address a primary concern under section 7(d) -- avoiding the United States sale of shares of foreign investment companies that are shells.

<sup>72</sup>The proposal would have authorized the Commission to revoke or modify any order issued under section 7(d) if it found: (1) that it was not legally or practically feasible effectively to  
(continued...)

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because section 38(a) specifically grants the Commission the authority to rescind or amend orders.<sup>73</sup> The Division sees no reason to include special standards for rescission within section 7(d).

## 5. Non-Public Offerings

The proposed amendment would include language to address when the Investment Company Act requires registration by foreign funds actively promoting the sale of their securities to United States residents in other than public offerings. Because it is difficult overseas to track United States resident ownership, a foreign fund should not be required to make determinations as to whether there are more than 100 United States residents who beneficially own its securities.<sup>74</sup> Because a continuous monitoring requirement is appropriate, however, a foreign fund should be required to monitor its shareholders of record.

Accordingly, the proposal would require a foreign fund not otherwise excepted from the definition of an investment company to register if it makes a public offer using United States jurisdictional means; it has used United States jurisdictional means in connection with any United States offering of its securities and has more than 100 shareholders of record who are United States residents; or it has taken steps to facilitate secondary market trading in its securities in the United States either by listing its shares on a securities exchange or having its shares quoted by any securities processor registered under the Exchange Act or by other means, and has more than 100 shareholders of record who are United States residents. The first of these circumstances reflects a foreign fund's registration obligation as currently provided under section 7(d); the second clarifies the language of the statute to reflect expressly the Commission's position in the release adopting rule 144A; and the third sets forth the remaining circumstances under which a foreign investment company may incur a registration obligation under the Investment Company Act.

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<sup>72</sup>(...continued)

enforce the provisions of the Investment Company Act to which the fund was subject; (2) that the fund was not primarily investing in the securities of non-United States issuers; or (3) that the laws under which the foreign fund operates did not provide investor protections that serve the same purpose as the provisions of the Investment Company Act from which exemptions were provided.

<sup>73</sup>15 U.S.C. § 80a-37(a).

<sup>74</sup>*See supra* Section II.G.

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This approach will not result in exact parity of treatment for foreign and domestic funds with respect to the 100 shareholder limitation,<sup>75</sup> but will eliminate most disparity without penalizing foreign funds that have never used United States jurisdictional means in any significant manner. The proposed amendment would not compel registration by a foreign fund that has never taken any steps either to offer its shares or to facilitate secondary market trading in the United States, even if it inadvertently has more than 100 shareholders who are United States residents.<sup>76</sup>

A "shareholder of record" standard would substitute for the "beneficial owner" standard currently used in calculating and tracing United States ownership for section 7(d) purposes. The shareholder of record concept would alleviate some of the problems foreign funds have in identifying and monitoring ownership by United States residents. In defining and interpreting the concept, the Division expects to look, in part, to analogous definitions set forth in rules 12g5-1 and 12g3-2(a) under the Exchange Act.<sup>77</sup>

Rule 12g5-1 provides that securities are deemed to be "held of record" by each person who is identified as the owner of the securities on the records of security holders maintained by or on behalf of the issuer, subject to certain qualifications. These qualifications pertain to specific circumstances under which questions could arise regarding the method of calculation. They also seek to prevent the use of artificial calculations as a means of circumventing the statute.<sup>78</sup> For example, the Division might look to rule 12g3-2 in interpreting who the holders of record would be in cases where foreign fund securities are held in street name for United States residents.<sup>79</sup> Similarly, one of the

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<sup>75</sup>United States investment companies must include both United States and foreign resident beneficial owners in their calculations for purposes of section 3(c)(1).

<sup>76</sup>The legislative history of the Investment Company Act indicates that, despite section 7(d), Congress expected some leakage of foreign fund shares into the United States. *1940 Senate Hearings, supra* note 20, at 199.

<sup>77</sup>17 C.F.R. §§ 240.12g5-1, .12g3-2(a)

<sup>78</sup>For example, subsection (b)(3) of rule 12g5-1 provides that if an issuer has reason to know that the form of holding securities of record is used primarily to circumvent the provisions of the Exchange Act, the beneficial owners of such securities shall be deemed to be the record owners of the securities.

<sup>79</sup>Rule 12g3-2 provides in pertinent **part**:

securities held **of** record by persons resident in the United States shall be determined as provided in Rule 12g5-1 . . . except that securities held of record by a broker, dealer, bank or nominee for any of them for the accounts of

(continued...)

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refinements provided by rule 12g5-1 that the Division might consider in the foreign investment company context is the manner in which holders of bearer securities are counted.<sup>80</sup> The Division expects that similar refinements of the "shareholder of record" concept in section 7(d) will assist foreign funds in calculating and tracing United States resident shareholders.

Using a shareholder of record standard, a foreign fund should be able to determine whether it is in danger of overstepping the 100 United States shareholder limit. Therefore, the 100 shareholder limitation should be ongoing, and not be restricted to a "snapshot" count taken immediately after the completion of a private offering, or one taken within a certain time period after the listing of a fund's securities on a securities exchange in the United States.

The Division believes that it would be inappropriate to place a registration obligation on a foreign fund that has never taken any steps either to offer its shares in the United States or to facilitate secondary market trading in the United States, but whose shares have inadvertently leaked into the United States.<sup>81</sup> Therefore, under the Division's proposal, such a fund would not be required to register, even if it has more than 100 shareholders of record that are United States residents.

#### **IV. Other Impediments to Cross-Border Sales**

In addition to section 7(d) and restrictive securities laws and practices in other countries, at least two other factors significantly impede cross-border sales of investment company securities: United States tax law and state "blue sky" laws.

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<sup>79</sup>(...continued)

customers resident in the United States shall be counted as held in the United States by the number of separate accounts for which the securities are held. The issuer may rely in good faith on information as to the number of such separate accounts supplied by all owners of the class of its securities which are brokers, dealers, or banks or a nominee for any of them.

\*Rule 12g5-1(a)(5), 17 C.F.R. § 240.12g5-1(a)(5).

<sup>81</sup>In defining and interpreting which steps would trigger a registration obligation, the Division expects to consider both analogous concepts set forth under other federal securities laws, e.g., "directed selling efforts" under Regulation S (17 C.F.R. § 230.902(b)), and the unique investor protection concerns of the Investment Company Act.

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## A. United States Tax Law

Without amendments to United States tax laws, securing greater access for United States funds overseas most probably will not meaningfully increase sales to foreign investors. The Division recommends that the Commission support proposals to eliminate the competitive tax disadvantages for United States investment companies marketing overseas.

United States distribution requirements and withholding standards provide a strong incentive for foreign investors to invest in foreign funds rather than in United States investment companies. Under subchapter M of the Internal Revenue Code, in order to avoid taxation at the investment company level, a United States registered fund must distribute at least ninety percent of its taxable income to its shareholders each year and is subject to tax on its undistributed taxable income.<sup>82</sup> Further, Internal Revenue Code section 4982 imposes an additional excise tax on a fund if it does not distribute ninety-seven percent of its ordinary income and ninety-eight percent of its capital gain net income to its shareholders.<sup>83</sup> If a fund operates within these limits, domestic shareholders receive the same tax treatment as if they owned their proportionate share of the fund's portfolio of securities directly.

Foreign investors, however, may not receive the same tax treatment under United States tax law. Foreign investors, upon receipt of fund distributions effectively mandated by subchapter M, have fifteen to thirty percent of the ordinary income and short-term capital gains distributions withheld from the distributions that they receive. Under some circumstances, if the foreign investor owned the fund's portfolio securities directly, the same income would not be subject to this withholding tax.<sup>84</sup> The net result is that foreign investors may incur a smaller United States tax liability by investing in securities directly rather than investing in a United States investment company.

Moreover, many foreign jurisdictions do not require an investment company to distribute income and realized capital gain in order to avoid tax at the fund level; in fact, many foreign countries do not impose any tax at the fund

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<sup>82</sup>26 U.S.C. § 852.

<sup>83</sup>26 U.S.C. § 4982.

<sup>84</sup>While dividends to foreign investors on United States publicly traded stocks normally are subject to withholding tax, most interest payments on short- and long-term capital gains realized by foreign investors from United States securities are generally exempt from withholding. Even though ordinary distributions by United States mutual funds are composed in large part of interest income and short-term capital gains, withholding tax still applies because mutual fund distributions are technically dividends on fund shares and are treated as such.

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level. The absence of a distribution requirement permits a shareholder in a foreign fund to enjoy tax-free buildup of earnings and to avoid paying any tax until the fund shares are redeemed. Further, since several foreign countries impose little or no capital gains tax, foreign fund shareholders pay little tax upon redemption.<sup>85</sup>

The difference in tax treatment for foreign investors in United States funds strongly suggests that any amendment to section 7(d) should be accompanied by an amendment to the Internal Revenue Code to reduce the disparity. It would make little sense to enact securities legislation that will encourage the sale of foreign investment company securities in the United States without at the same time eliminating a critical barrier to the sale of United States fund shares overseas. Of course, amending United States tax law in this area raises policy and revenue concerns, and any amendment to the Internal Revenue Code should take those concerns into account.

#### B. State "Blue Sky" Laws

In addition to satisfying registration requirements of section 7(d), a foreign investment company also must satisfy the applicable "blue sky" laws of each state in which it seeks to sell its securities. Because blue sky requirements vary among states, a foreign investment company selling throughout the United States would have to comply with numerous differing state blue sky requirements. This second layer of registration is arguably more burdensome for a foreign investment company than a United States investment company, since the former must also satisfy applicable regulatory requirements in its home country.

In light of the substantive federal regulation of investment companies and their investment advisers under the Investment Company Act, the Securities Act, and the Investment Advisers Act,<sup>86</sup> the merits of additional state substantive

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<sup>85</sup>For instance, in Germany, since capital gains retained by funds that are foreign EC registered UCITS are not taxable for private investors, investors can avoid taxation if the fund retains the capital gains. The investors might realize capital gains upon the sale of fund shares, but only if they had held the shares for fewer than six months. INT'L FIN. L. REV., *supra* note 68, at 103.

<sup>86</sup>Investment Advisers Act of 1940, 15 U.S.C. § 80b.

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review are debatable.<sup>87</sup> Critics argue that the costs to investors for state substantive review outweigh the benefits?

The diversity of each state's substantive and procedural blue sky requirements make compliance difficult. Critics point out that few of the various substantive requirements apply in more than a few states. For example, California is the only state that still prescribes an expense limitation. For an investment company seeking to sell in California as well as in other states, that expense limitation, in effect, establishes a nationwide standard. Critics also charge that, because of this diversity, investors who are citizens of states with rational regulatory fees and policies in effect subsidize those states with inefficient or expensive fees and policies.

The Division recommends that the Commission continue to work with state securities administrators to develop a means of coordinating and consolidating federal and state substantive regulation of investment companies. Any solution should preserve states' significant enforcement responsibility and provide that states continue to require, for notice purposes, filings of any documents filed with the Commission, consent to service of process, and requisite fees. These requirements are justifiably within the scope of states' legitimate interest in protecting their residents.

## V. Conclusion

The Division recommends amendments to section 7(d) of the Investment Company Act to give the Commission greater flexibility in permitting a foreign fund to register in the United States, and to clarify, in the absence of a public offering, when section 7(d) requires a foreign fund to register. The Division also recommends that the Commission work with state securities administrators to eliminate duplicative securities regulation. These efforts may encourage foreign jurisdictions to ease some of their legal and practical restrictions on United States investment companies seeking to market abroad. Finally, the competitive disadvantages for United States funds created by the Internal Revenue Code should be addressed, although we express no view on specific terms of any amendments to the Code.

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<sup>87</sup>For example, critics charge blue sky review is less than comprehensive. They suggest that state regulators "rarely if ever examine the merits of investment company offerings." See, e.g., Davis Polk Study Comment, *supra* note 45, at 71.

"Costs include actual filing fees and the expenses of fulfilling state filing requirements. Word processing expenses, collect telephone calls from state regulators, express mail charges, and legal, professional, and other personnel fees make filing expensive. Even blue chip exemptions, intended to reduce costs for investment grade securities, may be uneconomic for investment companies, since many expire after one year, at which time an additional fee is required.

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## APPENDIX 4-A

### **Red-Lined Version of Proposed Amendment to the Investment Company Act of 1940**

(new language is shaded; deleted language is struck through)

#### Section 7 [15 U.S.C. § 80a-71.]

\* \* \*

(d) (1) No investment company, unless organized or otherwise created under the laws of the United States or of a State, and no depositor or trustee of or underwriter for such a company not so organized or created, shall make use of the mails or any means or instrumentality of interstate commerce, directly or indirectly, to offer for sale, sell, or deliver after sale, in connection with a public offering, any security of which such company is the issuer ~~unless it has received a Commission order pursuant to paragraph (3) of this subsection.~~

(2) No investment company, unless organized or otherwise created under the laws of the United States or of a State, and no depositor or trustee of or underwriter for such a company shall make use of the mails or any means or instrumentality of interstate commerce, directly or indirectly,

(A) in the United States, to offer for sale, sell, or deliver after sale, any security of which such company is the issuer; or

(B) to facilitate secondary market trading in the United States, by listing the securities issued by such company on a registered securities exchange or by having its shares quoted by a registered securities information processor, or otherwise;

If such company has, or as a result of the activities in (A) or (B) can reasonably expect to have, more than 100 shareholders of record that are United States residents, unless such company has received a Commission order pursuant to paragraph (3) of this subsection.

(3) ~~Notwithstanding the provisions of this subsection and of section 8(a),~~ The Commission is authorized, upon application by an ~~operating foreign~~ investment company ~~not~~ organized or otherwise created under the laws of the ~~United States or of a State foreign country~~, to issue a conditional or unconditional

order permitting such company to register under this title and to make a public offering of its securities engage in the activities described in paragraphs (1) and (2) of this subsection by use of the mails and means or instrumentalities of interstate commerce, if:

(A) the Commission finds that, by reason of special circumstances or arrangements, it is both legally and practically feasible to enforce the f this title § the operating foreign investment f and that the issuance of such order is otherwise consistent with the public interest and the protection of investors; and

(B) the Commission and the securities regulator of the country in which the operating foreign investment company is organized or otherwise created have signed a regulatory memorandum of understanding providing for regulatory cooperation and mutual recognition of investment company regulation by that country and the United States;

(4) The Commission may by rule or order exempt operating foreign investment companies from any provision of this title if it finds that:

(A) such exemption is necessary or appropriate in the public interest;

(B) the laws under which such company operates provide protections for investors that serve the same purposes as the protections provided by the provisions of this title from which exemption is requested or that specific conditions agreed to by the company provide such investor protections;

(C) the exemption is consistent with the protection of investors and the purposes fairly intended by the policy of this title; and

(D) the company is not operated for the purpose of evading the provisions of this title.

For purposes of this section, an operating foreign investment company is a company that is not organized or otherwise created under the laws of the United States or of a State, is primarily engaged in investing in securities of non-United States issuers, and at all times during the three-year period immediately preceding the filing of an application for registration under this title has met criteria prescribed by Commission rule or order to demonstrate that it is a bona fide operating foreign investment company.

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## Chapter 5

# The Reach of the Investment Advisers Act of 1940

### I. Introduction and Summary of Recommendations

One area of great importance for the internationalization of investment management services is the reach of the Investment Advisers Act.<sup>1</sup> Under existing interpretations, the Advisers Act is applied on an "entity" basis. That is, when an investment adviser, whether foreign or domestic, registers under the Advisers Act, all of the adviser's activities everywhere are subject to the Act.<sup>2</sup> Many of the Advisers Act's provisions differ from or exceed those that apply to foreign advisers under the laws of their home country and also may be contrary to accepted business practices there. Consequently, a foreign adviser that registers under the Advisers Act because it does business with clients in the United States, as well as in its home country, may find itself unable to engage in conduct that is legal and acceptable business conduct in its home country because the Act prohibits it. To avoid this result, some foreign advisers establish "independent" subsidiaries, registered under the Advisers Act, to advise their clients here. Those subsidiaries, however, are subject to strict conditions that may reduce the amount and quality of investment advice available to investors in the United States.<sup>3</sup>

The Division has reexamined the current interpretations on the reach of the Advisers Act and concluded that they should be changed! We recommend

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<sup>1</sup>Investment Advisers Act of 1940, 15 U.S.C. § 80b.

<sup>2</sup>See *infra* note 7 and accompanying text. We use "domestic adviser" to refer to an adviser whose offices and personnel are located in the United States and "foreign adviser" to refer to an adviser whose offices and personnel are located outside the United States.

<sup>3</sup>See *infra* notes 9-15 and accompanying text.

<sup>4</sup>The Commission received eight comments on this topic in response to SEC Request for Comments on Reform of the Regulation of Investment Companies, Investment Company Act Release No. 17534 (June 15, 1990), 55 FR 25322, all critical of the current positions. The commenters were certain members of a subcommittee of the American Bar Association; Citicorp; Cleary, Gottlieb, Steen & Hamilton; Davis Polk & Wardwell; Debevoise & Plimpton, on behalf of Westpac Banking Corporation; Dechert Price & Rhoads; Ropes & Gray; and Kathleen A. Veach. In addition, Debevoise & Plimpton, with the assistance of several other law firms, provided the Division with a memorandum entitled *International Survey of Investment Adviser Regulation* (Aug., (continued...)

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applying the Advisers Act on a more narrow basis tied to "territorial" concepts focusing on conduct and the effect of conduct. Under such an approach, the Advisers Act would apply to activities where a sizable amount of advisory services takes place *in the United States* or where the advisory services have effects *in the United States*. Thus, where a registered foreign adviser or a registered domestic adviser deals with clients resident in the United States, it can be assumed that a sizable amount of advisory services will take place in the United States and that there will be effects in the United States and the Advisers Act will apply. Where, however, a registered foreign adviser deals with a client residing outside the United States, the Advisers Act generally will not apply. A more difficult question arises where a registered domestic adviser deals with a client residing outside the United States. In such a case, a sizable amount of advisory services is likely to take place in the United States and the Advisers Act ordinarily will apply. Another difficult question arises where either a foreign or a domestic adviser is multinational, that is, has offices outside its foreign or domestic base. Here again, application of the Advisers Act will depend on whether a sizable amount of advisory services takes place in the United States. Thus, for instance, if a domestic adviser has a branch office in a foreign country, and has a corporate policy requiring that all portfolio decisions regarding clients residing in that country come from that foreign office, then the Advisers Act generally would not apply. If, on the other hand, the client wishes to invest in United States markets and the firm's personnel located in the United States are involved in formulating or providing advice, the Advisers Act generally would apply! Because of the fact-specific nature of these issues, close cases would be addressed on a case-by-case approach through interpretive and no-action letters.

Although the approach we recommend would lessen the need to create separate subsidiaries, some investment advisers still may wish to form separate entities. We recommend revision of the criteria for the formation and registration of separate subsidiaries.

This chapter begins with a discussion of the existing positions on the reach of the Advisers Act and some of the interpretive and practical difficulties they present. It then discusses a new approach to application of the Advisers Act, based upon conduct and effect of conduct, and the policy considerations that

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<sup>4</sup>(...continued)

1990) [hereinafter *International Survey*] with analyses of the investment advisory laws of Australia, Brazil, France, Germany, Japan, Switzerland, and the United Kingdom.

<sup>5</sup>In Chapter 6, however, we recommend legislation that would authorize the Commission to exempt from the Advisers Act's prohibition on performance-based advisory fees with persons not residing in the United States to the extent that such fees are lawful in the client's country of residence.

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support that approach. This chapter also describes the alternatives that the Division considered but does not recommend.

## II. The Reach of the Investment Advisers Act -- The Current Approach

Section 203 of the Advisers Act requires the registration of any investment adviser, whether domestic or foreign, that uses the United States mails or any other means or instrumentality of interstate commerce in connection with its business as an investment adviser, unless the adviser is exempted from registration? The Division has stated that, once registered, domestic and foreign advisers are subject to all the substantive provisions of the Advisers Act with respect to both their United States and non-United States clients?

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<sup>6</sup>Section 202(a)(10) defines "interstate commerce" to include "trade, commerce, transportation, or communication . . . between any foreign country and any State. . ." 15 U.S.C. § 80b-(a)(10). Section 202(a)(11) defines an "investment adviser" to mean, with certain exceptions, "any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities . . ." A foreign adviser to clients residing outside the United States may use limited United States jurisdictional means without triggering the registration requirements of the Advisers Act; that is, it may acquire information about securities of United States issuers and effect transactions in securities through United States broker-dealers. Gim-Seong Seow (pub. avail. Nov. 30, 1987). In contrast, a domestic adviser dealing exclusively with foreign clients must register if it uses any jurisdictional means in connection with its advisory business. *Id.*

The Advisers Act exempts from registration any adviser that has fewer than 15 clients and that neither holds itself out as an adviser nor acts as an adviser to any registered investment company. Investment Advisers Act § 203(b)(3), 15 U.S.C. § 80b-3(b)(3). Domestic advisers and foreign advisers have been treated differently in determining whether foreign clients should be counted. Domestic advisers are required to count foreign clients; foreign advisers are not. See, e.g., Murray Johnstone Ltd. (pub. avail. Apr. 17, 1987); Alexander, Holburn, Beaudin & Lang (pub. avail. Aug. 13, 1984); S&R Management Co. (pub. avail. May 8, 1975). But see Walter L. Stephens (pub. avail. Nov. 18, 1985) (indicating no distinction).

Section 203(b) also exempts from registration certain "intrastate" advisers and advisers to insurance companies. The Advisers Act's antifraud provision, section 206 (15 U.S.C. § 80b-6), by its terms applies to any adviser, whether or not required to register, that is using the jurisdictional means.

<sup>7</sup>Reavis & McGrath (pub. avail. Oct. 29, 1986). On one occasion, a registered foreign adviser received a no-action response where it proposed not to comply with the performance fee limits, among other things, with respect to its home country clients. **Nikko Sec. Inv. Trust & Management Co., Ltd.** (pub. avail. May 17, 1985). Since the response concerned only performance fees and one other aspect of adviser regulation, the adviser presumably was required to comply  
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This poses a number of problems for foreign advisers. For example, a registered foreign adviser that provides advice both to United States clients and to clients in its own country may find that it is unable to engage in legal and acceptable business conduct in its home country because the Advisers Act prohibits the conduct. The most striking example of this is the use of performance-based advisory fees. While advisory fees based on investment performance are legal and in fact accepted business practice in many countries, the Advisers Act restricts their use.<sup>8</sup> Thus, a foreign adviser that registers in the United States to advise United States clients finds that it is prohibited from entering into fee arrangements with clients in its home country that are otherwise lawful in that country.

To avoid this broad reach of the Advisers Act, a foreign adviser may form a separate and independent subsidiary to provide advice to United States clients. Under current positions, however, such a subsidiary will only be "regarded as having a separate, independent existence and to be functioning independently of its parent," thereby permitting the foreign parent to remain unregistered, if the subsidiary satisfies the following five conditions (known as the "*Ellis* conditions," after the no-action letter in which they were set forth)? The subsidiary must: (1) be adequately capitalized; (2) have a "buffer" between the subsidiary's personnel

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'(...continued)

with the other provisions of the Advisers Act, including the recordkeeping and antifraud provisions, with respect to all of its clients. This was ~~an~~ "enforcement only" response, however, not an interpretive one, and the Division subsequently indicated that all provisions of the Advisers Act apply to a registered adviser's dealings with foreign clients. Reavis & McGrath, *supra*.

The Commission has taken a similar position with regard to broker-dealers registered under the Securities Exchange Act of 1934 (15 U.S.C. §§ 78a-78ll). Once a broker-dealer is registered, it is subject to the full panoply of United States broker-dealer regulations. See Registration Requirements for Requirements for Broker-Dealers, Exchange Act Release No. 27017, at III.A, III.B.1 (July 11, 1989), 54 FR 30013 ("if a foreign brokerdealer . . . becomes subject to U. S. registration requirements, . . . the regulatory system governing U.S. broker-dealers would apply to the entire brokerdealer entity").

'Advisers Act § 205(a)(1), 15 U.S.C. § 80b-5(a)(1). See Chapter 6 for the Division's recommendations concerning performance fees.

<sup>8</sup>Richard Ellis (pub. avail. Sept. 17, 1981). The status of separate affiliates under common control has not been definitively resolved. Compare H.P. Hambrick Co., Inc. and Pajolo A.G. (pub. avail. Oct. 14, 1988) (indicating that questions could arise where a United States resident adviser provides advisory services to foreign clients through an unregistered wholly owned foreign corporation, particularly where the individual also provides advice to United States clients through another wholly owned corporation registered as an adviser with the Commission) *with* TAC America, Ltd. (pub. avail. July 25, 1984) and Double D Management Ltd. (pub. avail. Jan. 31, 1983) (performance fee provisions of the Advisers Act not applicable to unregistered foreign affiliates of registered advisers, even where the affiliates have common personnel).

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and the parent, such as a board of directors a majority of whose members are independent of the parent; (3) have 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) itself make 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 information not limited to its parent; and (5) keep its investment advice confidential until communicated to its clients.<sup>10</sup> All five criteria were believed to be necessary to establish that the parent company was not doing indirectly under the Advisers Act what it could not do directly, in violation of section 208(d).<sup>11</sup>

While the *Ellis* conditions were designed to ameliorate the problems created by the Division's interpretations of the reach of the Advisers Act, they

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<sup>10</sup>The *Ellis* conditions were derived from a 1972 Commission release proposing a rule that would have set forth virtually identical conditions under which an affiliate formed to provide advisory services would be deemed an autonomous entity. The Commission noted, however, that "[w]hether a registered investment adviser is merely a conduit for advisory services provided by its controlling person or ~~an~~ affiliate of such controlling person, depends in each case upon the substance of the arrangement." Notice of Proposals under the Investment Advisers Act to (1) Adopt New Rule 202-1 under the Investment Advisers Act of 1940, as amended ("Advisers Act"), with respect to Exemption from the Definition of "Investment Adviser," and (2) Amend Rule 204-2(a) under the Advisers Act by Amending Paragraph (12) and Adopting New Paragraphs (13) and (14) thereunder with respect to Record-Keeping Requirements for Certain Investment Advisers under the Advisers Act, Investment Advisers Act Release No. 353 at n.2 and accompanying text (Dec. 18, 1972), 38 FR 1649. The proposed rule (redesignated Advisers Act proposed rule 202-2 in Investment Advisers Act Release No. 369 (Feb. 21, 1973), 36 FR 5912) would have provided an exemption from registration for the company controlling the registered adviser and affiliates ~~of~~ the controlling company if the enumerated conditions were satisfied. *Id.* at 1650. The Commission withdrew the proposed rule in 1976 without explanation. Notice of Withdrawal of Proposed Rule 202-2 under the Investment Advisers Act of 1940, Investment Advisers Act Release No. 497 (Feb. 19, 1976), 41 FR 8498.

<sup>11</sup>15 U.S.C. § 80b-8(d). Section 208(d), which was added in 1960 (Pub. L. No. 86-750, § 11(b), 74 Stat. 885, 887), provides: "[i]t shall be unlawful for any person indirectly, or through or by any other person, to do any act or thing which it would be unlawful for such person to do directly under the provisions of this title or any rule or regulation thereunder." The legislative history of the section indicates that it is based on section 20(b) of the Exchange Act (15 U.S.C. § 78t(b)). See S. REP. NO. 1760, 86th Cong., 2d Sess. 8 (1960). The Exchange Act, however, has not been interpreted to require compliance with conditions similar to those in *Ellis* in establishing a separate broker-dealer affiliate. In determining whether a foreign broker-dealer must register, the Commission has indicated that sharing personnel with a registered entity is permissible, as long as the registered entity maintains appropriate supervision and control of shared personnel, and certain other conditions are met. Exch. Act Rel. 27017, *supra* note 7, 54 FR at 30017 ("the Commission believes that it is consistent with these principles for a registered representative stationed outside the United States with a foreign broker-dealer to contact personnel in the United States from within or without this country on behalf of the registered broker-dealer"). The foreign broker-dealer may not control the registered broker-dealer's day-to-day market making activities, however. See *id.* at n.205 and accompanying text.

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pose great difficulties in practice?" The separate personnel requirement, in particular, has harsh effects. A foreign parent adviser may be unable to employ its most talented portfolio managers on United States accounts, since such portfolio managers may be required to bring their specialized expertise to bear on a larger proportion of business represented by non-United States accounts served by the parent. It is probably unrealistic to expect that a foreign adviser would make a valuable portfolio manager unavailable to its non-United States clients by transferring the manager to a subsidiary registered under the Advisers Act. Finding another portfolio manager with equivalent expertise to work in the registered subsidiary is inefficient and may be impossible. Thus, as a practical matter, because of the *Ellis* conditions, United States clients may have limited access to advisory personnel with expertise in particular specialized markets.<sup>13</sup>

The *Ellis* conditions concerning the flow of information also may have deleterious consequences. While portfolio managers working in a registered subsidiary have the benefit of research materials generated by the parent, and may participate in some circumstances in discussions with personnel of the parent concerning current trends and allocation of portfolios between industries and national markets, the conditions may prohibit day-to-day exchanges of ideas and discussions between portfolio managers of the parent and subsidiary. As a result, a foreign adviser's ability to provide the best available service to United States clients likely is impeded.

In addition, while *Ellis* requires the registered subsidiary of a foreign adviser to be adequately capitalized, *Ellis* does not provide any guidance as to what constitutes adequate capitalization.<sup>14</sup> Investment advisers do not have to meet capital requirements under the Advisers Act.<sup>15</sup> Finally, assuming that an

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<sup>12</sup>The *Ellis* conditions have been characterized as "unworkable." Greene, Dupler, and Cohen, *Jurisdictional Reach of the Investment Advisers Act of 1940*, INSIGHTS, Oct. 1990, at 21/27 (1990).

<sup>13</sup>See Letter from Davis Polk & Wardwell to Jonathan G. Katz, Secretary, SEC 27-29 (Oct. 10, 1990), File No. S7-11-90.

<sup>14</sup>Inv. Adv. Act Rel. 353, *supra* note 10, when proposing the rule originally proposed as Advisers Act rule 202-1, appeared to suggest that all that was required was sufficient capital to avoid the affiliate being a shell. Inv. Adv. Act Rel. 353, *supra* note 10. If this is the capital level to which *Ellis* refers, it would not appear burdensome, being essentially consistent with state corporate law concepts of separateness.

<sup>15</sup>Many states impose a net capital or minimum net worth requirement. E.g., N.C. GEN. STAT. § 78C-17. Other states apparently have the authority to do so, but have not exercised that authority. E.g., S. D. CODIFIED LAWS ANN. § 47-31A-202 (119). At least one state, Arkansas, exempts investment advisers registered under the Advisers Act from that state's capital requirements. ARK. STAT. ANN. § 23-42-303(b).

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adequate level of capital could be determined, this condition nonetheless requires a foreign adviser to divide its capital for seemingly artificial purposes.

## **111. A Conduct and Effects Application of the Investment Advisers Act**

### **A. The Statute's Jurisdictional Reach**

The language of the Advisers Act does not contain explicit territorial restrictions, except that a number of provisions require the use of jurisdictional means to establish a violation.<sup>16</sup> Other parts of the federal securities laws also lack explicit territorial limits. The Commission, through rulemaking and interpretation, has sought to balance the literal reach of those provisions with the legislative purpose underlying the particular statute, principles of international law as recognized in the United States, and the realities of global markets.<sup>17</sup> This has resulted in an emphasis on territorial limits in applying the regulatory requirements of the federal securities laws, with the precise limits being determined by reference to the language, legislative history, and purposes of the specific provision at issue.

Generally, statutes are applied to regulate activity taking place outside the United States where that activity produces substantial and foreseeable effects in the United States or involves conduct occurring in the United States, even if the conduct has no effect on United States persons or markets. These principles of jurisdiction -- known as the "conduct" and "effects" tests -- are well-established in other areas of the law and have been applied frequently in determining the application of the federal securities laws to foreign persons and conduct.<sup>18</sup>

The conduct and effects tests have been most often used as bases for asserting jurisdiction under the federal securities laws' antifraud provisions.

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<sup>16</sup>Despite this absence of restrictions, the Advisers Act's substantive regulations have not been applied with respect to foreign advisers with *de minimis* connection to or activity in the United States. See *supra* note 6.

<sup>17</sup>One example is the Commission's approach under the Securities Act of 1933 (15 U.S.C. §§ 77a-77aa), which is codified in Regulation S (17 C.F.R. §§ 230.901-.904). See Offshore Offers and Sales, Securities Act Release No. 6863 (Apr. 24, 1990), 55 FR 18306. In regulating broker-dealers, the Commission uses a territorial approach in applying the registration requirements, but regulates registered broker-dealers under an entity approach. See Exch. Act. Rel. 27017, *supra* note 7, at III.B.1.

<sup>18</sup>See *infra* notes 19-22. See also RESTATEMENT (THIRD) OF THE FOREIGN RELATIONS LAW OF THE UNITED STATES § 402 (1987) [hereinafter RESTATEMENT (THIRD)]; RESTATEMENT (SECOND) OF FOREIGN RELATIONS LAW OF THE UNITED STATES §§ 17/18 (1965).

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Under the conduct test, acts that are committed in the United States in furtherance of a fraudulent scheme and are more than merely preparatory are sufficient to justify application of the federal securities laws to the unlawful conduct.<sup>19</sup> Courts have concluded that Congress did not intend for this country to be used as "a base for manufacturing fraudulent security devices for export,"<sup>20</sup> or to become "a 'Barbary Coast' . . . harboring international securities 'pirates'" whose victims are foreign.<sup>21</sup> Under the "effects" test, the federal securities laws may be applied to conduct overseas that injures or defrauds United States investors or adversely affects a United States listed security.<sup>22</sup>

The antifraud provisions of the securities laws have typically been given broader effect than purely regulatory provisions.<sup>23</sup> Nevertheless, if the effect in the United States is sufficiently significant, or the conduct sufficiently important, the assertion of regulatory jurisdiction is appropriate.<sup>24</sup>

## B. Policy Considerations Favoring a New Approach

The Division believes that a conduct and effects approach to the Advisers Act is consistent with important policy considerations and that the Act should be

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<sup>19</sup>See, e.g., Leasco Data Processing Equip. Corp. v. Maxwell, 468 F.2d 1326 (2d Cir. 1972) and Continental Grain (Australia) Pty. Ltd v. Pacific Oilseeds, Inc., 592 F.2d 409, 421 (8th Cir. 1979) (misrepresentations made in the United States for securities transactions consummated abroad); cf. Psimenos v. E.F. Hutton & Co., 722 F.2d 1041, 1045 (2d Cir. 1983) (fraudulent practices with respect to foreign client prohibited by United States law where practices concerned trades executed for client on United States commodity exchange).

<sup>20</sup>IIT v. Vencap, Ltd., 519 F.2d 1001, 1017 (2d Cir. 1975).

<sup>21</sup>SEC v. Kasser, 548 F.2d 109, 116 (3d Cir. 1977), cert. denied, 431 U.S. 938 (1977).

<sup>22</sup>See, e.g., Consolidated Gold Fields, PLC v. Minorco, S.A., 871 F.2d 252 (2d Cir. 1989); Bersch v. Drexel Firestone, 519 F.2d 974, 993 (2d Cir. 1975), cert. denied, 423 U.S. 1018 (1975); Schoenbaum v. Firstbrook, 405 F.2d 200 (2d Cir. 1968), rev'd on other grounds, 405 F.2d 215 (2d Cir. 1968) (en banc), cert. denied, 395 U.S. 906 (1969).

<sup>23</sup>See Plessey Co., PLC v. General Electric Co., 628 F. Supp. 477 (D. Del. 1986); see also Consolidated Gold Fields, 871 F.2d at 262-63 (distinguishing between the enforcement of United States regulatory and antifraud jurisdiction).

<sup>24</sup>Indeed, the RESTATEMENT (THIRD) recognizes the regulation of investment advice rendered in the United States as a reasonable assertion of regulatory jurisdiction. RESTATEMENT (THIRD), *supra* note 18, § 416.

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applied more narrowly, in keeping with that approach.<sup>25</sup> Under general principles of comity, nations recognize legislative and judicial acts of other nations, having due regard for the rights of their own citizens. Comity suggests that the Advisers Act should not apply to a foreign registered adviser's relationship with its non-United States clients outside the United States, just as the Commission would not expect the laws and regulations of a foreign country to apply to a United States adviser's relationship with its United States clients.<sup>26</sup>

A strong argument also can be made that foreign clients of foreign advisers do not expect, and may not desire, a foreign adviser to be subject to the Advisers Act. Assuming a foreign adviser does not hold itself out as being registered under the Advisers Act, there would be no apparent reason for a foreign investor to expect to be protected by United States law.

In addition, a conduct and effects approach is consistent with Commission efforts to remove unnecessary barriers to international securities markets. Today, foreign investment advisers may be reluctant to register under the Advisers Act so that they may advise United States clients because to do so subjects all their non-United States advisory operations to United States law. Their avoidance has the unfortunate effect of limiting United States investors' access to foreign advisory expertise.

Just as important, under a conduct and effects approach, the Commission still would be able to reach conduct that affects United States markets and United States clients. For example, where a foreign adviser's dealings with non-United States clients operate to defraud its United States clients, such as where the adviser was "front-running" trades of United States clients, the Advisers Act would apply since the acts would affect a United States client. Given these protections, little purpose is served by requiring foreign advisers to comply with all of the United States requirements regarding their non-United States clients.

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<sup>25</sup>Several commenters recommended a similar approach on policy grounds, as have other observers. See, e.g., Letter from Dechert Price & Rhoads to Jonathan G. Katz, Secretary, SEC 26 (Oct. 10, 1990), File No. S7-11-90 [hereinafter Dechert Price Study Comment]; Greene, Dupler, and Cohen, *supra* note 12.

<sup>26</sup>We understand the laws of other countries generally reflect these principles. For example, the United Kingdom does not apply certain of its investment advisory laws to the foreign activities of foreign investment advisers registered there. See Rule 28.01 of the Rules of the Investment Management Regulatory Organization Limited (1988) [hereinafter IMRO Rules]. Brazil's regulations do not apply to activities of registered investment managers outside Brazil. *International Survey*, *supra* note 4, at 111-13. Japanese law does not apply to the dealings between registered foreign-based advisers and their clients located outside Japan. *Id.* at VI-40. France applies its laws extraterritorially, *id.* at xviii-xix, but the activities of affiliates apparently are not subject to review to ensure separateness from the entity seeking to register. *Id.* at IV-2.

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We recognize that the approach we recommend may appear to differ from that taken by the Commission with respect to broker-dealer regulation. A closer look, however, reveals that the underlying rationale is entirely consistent. It is appropriate to use an entity analysis to apply the broker-dealer provisions of the Exchange Act to the foreign activities of a registered broker-dealer, for example, because of the consequences of such activities for the broker-dealer's net capital position. The Advisers Act, however, emphasizes disclosure and fiduciary obligations and does *not* regulate financial safety and soundness.<sup>27</sup> Accordingly, conduct by a registered foreign adviser outside the United States, with non-United States clients, is much less likely to implicate United States regulatory concerns.

### C. Access to Books and Records and Personnel

Although the activities of a registered foreign adviser with its foreign clients should not generally be subject to the Advisers Act, the Commission should require United States registered foreign advisers to keep certain records with respect to their offshore activities.<sup>28</sup> Because the offshore activities of a registered foreign adviser may have a significant effect on United States clients, these records will enable the Commission to carry out an effective examination program. In addition, the Commission will need access to foreign personnel of the adviser, even where those personnel do not deal with United States clients. The Commission's interest in the offshore activities of a registered foreign adviser, however, will generally be limited to obtaining access to information concerning trades by the adviser and its affiliates and foreign clients in order to monitor and enforce compliance with the adviser's obligations to its United States clients.

### D. Implications of a New Approach

The implications of the approach we recommend, for both foreign and domestic advisers, are discussed below. Of course, in some cases, determination of whether the Advisers Act applies will be fact-specific.

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<sup>27</sup>From time to time, various persons, including the Commission, have suggested amending the Advisers Act to impose capital requirements on investment advisers. If the Advisers Act were amended to address financial safety and soundness concerns, we would expect to revisit this topic.

<sup>28</sup>Rule 204-2 under the Advisers Act (17 C.F.R. § 275.204-2) already requires, among other things, that registered advisers maintain records of not only their trades, but also of trades by any controlling persons or affiliates thereof who obtain information about investment advice before it is effectively disseminated.

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## **1. Foreign Advisers and United States Clients**

The conduct and effects approach generally would not affect the regulation of the relationships between registered foreign advisers and United States clients. If a foreign adviser has fifteen or more United States clients, it must register under the Advisers Act. Once registered or required to be registered, all of the foreign adviser's advisory activities with United States clients would be subject to the full panoply of the Advisers Act's requirements. This can be justified on either a conduct or effects basis -- sizable activity will take place in the United States or there will be an effect in the United States.

One issue that would arise more frequently under this approach is who is a "United States client" protected by the Advisers Act.<sup>29</sup> For example, while undoubtedly all persons resident in the United States are protected, the status of United States citizens abroad as clients protected by the Advisers Act has not been addressed. If the Commission takes a conduct and effects approach to the reach of the Advisers Act, we would expect to address these questions on a case-by-case basis through no-action letters, using criteria similar to those in Regulation S and rule 15a-6.<sup>30</sup>

## **2. Foreign Advisers and Clients Outside the United States**

Under a conduct and effects approach, the Advisers Act generally would not govern the relationship between a registered foreign adviser and its clients residing outside the United States. In this situation, the United States would not have a significant regulatory interest because the relationship would involve neither clients, nor advisory services rendered, within the United States. Also, if a nonresident adviser does not hold itself out to foreign persons as being registered under the Advisers Act, an expectation of protection under the Advisers Act is unlikely.<sup>31</sup> Finally, a foreign regulator would have a much

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<sup>29</sup>Under the existing positions, the question arises only in connection with determining whether a foreign adviser may rely on the exemption in section 203(b)(3) for advisers with fewer than 15 clients. See *supra* note 6.

<sup>30</sup>Regulation S generally deems United States citizens residing abroad as outside the protections of the registration requirements of the Securities Act. Rule 902(o) thereof defines "United States person" to include, among others, any natural person resident in the United States, but does not include United States citizens resident abroad. Rule 15a-6 under the Exchange Act (17 C.F.R. § 240.15a-6), adopts an approach similar to that of Regulation S. See Exch. Act. Rel. 27017, *supra* note 7, at III.B.2.

<sup>31</sup>In adopting a conduct and effects approach, the Commission could prevent registered foreign advisers that do not want their activities outside the United States to be governed by the Advisers Act from holding themselves out to foreign clients as being subject to Commission  
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greater interest than the United States in regulating investment advice given within its territory to persons located there.

At the same time, the offshore activities of a registered foreign adviser may have a significant effect on United States clients. Abusive practices such as front running and unauthorized principal and agency cross transactions involving the accounts of foreign clients or foreign affiliates could harm United States investors. For example, an adviser might sell a security from a foreign client's account to the account of a United States client without receiving written authorization from the United States client in contravention of section 206(3) of the Advisers Act, which addresses such agency cross-transactions, or place foreign client transactions ahead of a large transaction by a United States client. In our view, the Advisers Act should be applied to such activities because they involve United States clients.

### **3. Domestic Advisers and Foreign Clients**

When a domestic adviser is advising foreign clients, it is likely that a sizable amount of the advisory activity will occur in the United States. Where the investment advice is being provided by a domestic adviser and where its employees providing the advice are based in the United States, the United States has a significant regulatory interest in the activity and application of the Advisers Act is appropriate.

A foreign client doing business with an adviser located in the United States would be justified in expecting the protections afforded by United States law. When a client chooses to deal with advisory personnel located in the United States, the client chooses to have the relationship governed by United States law.<sup>32</sup>

We note that this approach means that a person in a foreign country who seeks the advice of an investment adviser located in the United States would find that the advisory relationship is subject to all the provisions of the Advisers Act. Thus, were a foreign pension fund to hire a domestic investment adviser to manage a portion of its portfolio, all provisions of the Advisers Act would apply

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<sup>31</sup>(...continued)

**regulation. Cf. IMRO Rule 16.11 (that advertisements of IMRO membership by investment managers for use outside the United Kingdom also must state that the rules and regulations under the United Kingdom's Financial Services Act pertaining to investor protection do not apply to those foreign investment managers).**

**<sup>32</sup>When a foreign client deals with advisory personnel located abroad, however, it may be appropriate that the relationship be governed by foreign laws, even if the adviser's main offices are in the United States.**

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to that relationship, including the restrictions on performance fees and principal transactions with clients.<sup>33</sup>

#### **4. Multinational Advisers and Foreign Clients**

The most difficult questions under the conduct and effects approach would arise with multinational firms, *i.e.*, firms with offices in the United States and at least one other country. A multinational advisory firm may deal with a foreign client with personnel from offices in numerous countries. In the case of such a firm, it will be necessary to determine whether a sizable amount of advisory services takes place in the United States, such that United States regulatory interest is justified. At one extreme, if a foreign client deals exclusively with the foreign office of a multinational firm that has a corporate policy requiring that all portfolio decisions made by that office be formulated by that office, the Advisers Act generally would not apply. At the other extreme, if the client wished to invest in United States markets and dealt exclusively with United States personnel, the Advisers Act would apply. Cases between these extremes may present difficult questions.

Until we have the opportunity to address the difficult questions, we are reluctant to draw definitive lines. The Division expects to provide guidance on a case-by-case basis, where appropriate, through letters. After we have had the opportunity to explore the various questions that necessarily will arise, we will recommend that the Commission codify that approach.

#### **5. Establishing Separate Entities**

Adoption of a conducts and effects approach would lessen the need for foreign advisers to organize and register separate entities. Nevertheless, there may be some foreign advisers who, for a variety of reasons, may wish to use a separate registered entity either in the United States or abroad. We believe that it would be consistent with a conduct and effects approach to modify the *Ellis* conditions for the registration of a separate affiliate.

We believe the Commission should recognize separateness if the affiliated companies are separately organized (*e.g.*, two distinct entities), and if the registered entity is staffed with personnel (whether physically located in the

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<sup>33</sup>Section 205(a)(1)'s restrictions on performance fees go beyond those in some other countries, although the section has a limited exception for contracts with investment companies and clients with accounts of \$1 million or more, and the Commission has adopted an exemptive rule for certain other contracts with sophisticated clients. Advisers Act rule 205-3, 17 C.F.R. § 275.205-3. In Chapter 6, the Division recommends amending section 205 to permit registered investment advisers to enter into performance fee arrangements with clients not residing in the United States under certain conditions.

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United States or abroad) who are capable of providing investment advice. Of course, there would still be a need to evaluate the separate identity of affiliates to ensure that all personnel involved in providing advice to United States persons and all supervisory personnel are subject to Commission jurisdiction. We see no reason to require separate boards, however, nor would we object to the sharing of personnel or communications. To ensure compliance with the Advisers Act, the Commission should require that all personnel involved in United States advisory activities be "associated persons" of the registrant and subject to the supervision of the registrant.<sup>34</sup> In addition, the Commission should have access to trading and other records of the affiliate, and to its personnel, to the extent necessary to monitor and police conduct that may harm United States investors.<sup>35</sup> Thus, we would recommend requirements generally analogous to those in rule 15a-6 under the Exchange Act.<sup>36</sup>

## E. Other Alternatives

The Division considered three alternatives to the conduct and effects approach: "nationality," "local law for local clients," and applying the Advisers Act's antifraud provisions, but not its regulatory provisions (such as its recordkeeping requirements), to dealings with foreign clients.

The first alternative, the "nationality" doctrine, postulates that a nation has an interest in applying its law to its citizens, wherever they are located and regardless of where conduct or effects occur. This approach is generally disfavored and has not been extensively applied by the courts.<sup>37</sup> Accordingly, we do not recommend it.

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<sup>34</sup>Under section 202(a)(17) of the Advisers Act, persons associated with an investment adviser include "any partner, officer, or director of such investment adviser (or any person performing similar functions), or any person directly or indirectly controlling or controlled by such investment adviser, including any employee of such investment adviser, . . . [but not] persons . . . whose functions are clerical or ministerial. . . ."

<sup>35</sup>See *supra* text following note 31.

<sup>36</sup>Rule 15a-6 requires, among other things, that an unregistered broker-dealer relying on the rule effect transactions through a registered broker-dealer and that the registered broker-dealer obtain from the foreign broker-dealer certain information required by the broker-dealer recordkeeping rules and a consent to service of process for any civil action brought by or proceeding before the Commission or a self-regulatory organization.

<sup>37</sup>See *Laker Airways Ltd. v. Sabena Belgian World Airlines*, 731 F.2d 909, 934-37 (D.C. Cir. 1984)(rejecting assertion of nationality as the "paramount" basis of jurisdiction); *Bersch v. Drexel Firestone, Inc.*, 519 F.2d at 992 (concluding the antifraud provisions would not be applied solely on basis of nationality to United States nationals residing abroad).

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The second alternative, the so-called "local law for local clients" approach, was advocated by a few commenters.<sup>38</sup> Under their approach, the Advisers Act would not apply to a United States adviser's dealings with clients residing outside the United States, even where the advice is formulated and provided by persons residing in the United States.

The arguments in favor of a local law for local clients approach are largely competitive. Supporters say that United States advisers are at a competitive disadvantage because the Advisers Act in some ways is more restrictive than the systems of regulation imposed by many foreign laws, so that, in addition to complying with the laws and regulations of the country in which the client is located, United States advisers have the added burden of complying with the Advisers Act -- a burden not shared by foreign advisers. Thus, for example, United States advisers of foreign clients would not be able to enter into the same types of fee arrangements as foreign advisers.<sup>39</sup>

Although we are sympathetic to the competitive concerns, we believe the local law for local clients approach is inconsistent with the purposes of the Advisers Act, general principles of jurisdiction, and the expectations of investors. In our view, the better approach is to apply the Advisers Act where a domestic adviser's dealings with foreign clients involve a sizable amount of activity *in the United States*.

As the courts have recognized, the United States and the Commission have a strong interest in preventing this country from being used as a base for fraudulent or abusive practices by investment advisers. It is not realistic to expect other countries to police the activities of United States advisers, particularly where those advisers may be conducting only limited solicitation and other marketing activities abroad.

The third alternative, applying only the antifraud provisions of the Advisers Act to dealings with foreign clients and not the regulatory provisions, has some basis under the securities laws. As noted above, in interpreting the scope of the securities laws, courts have indicated that the antifraud provisions

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<sup>38</sup>See, e.g., Letter from Cleary, Gottlieb, Steen & Hamilton to Jonathan G. Katz, Secretary, SEC 76 (Oct. 12, 1990), File No. S7-11-90; Dechert Price Study Comment, supra note 25, at 27.

<sup>39</sup>In theory, one effect of the competitive disadvantage might be that investment advisers would be less likely to base their operations in the United States because, while they can serve United States clients by simply registering in this country, they can avoid regulation under the Advisers Act with respect to foreign clients by locating outside the United States. We do not believe this is particularly likely because, among other things, advisers that desire to develop United States market expertise and to deal with United States clients will undoubtedly find it helpful or necessary to have personnel located here.

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have wider scope than do other regulatory provisions.<sup>40</sup> Similarly, in adopting Regulation S the Commission determined that the registration provisions of section 5 of the Securities Act generally should not apply to issuers' sales of securities outside the United States, but did not limit the reach of the antifraud provisions.<sup>41</sup>

On balance, however, we generally believe that the Commission should apply all of the Advisers Act to the dealings of United States advisers with foreign clients where a sizable amount of the advisory activity occurs in the United States. Most of the substantive provisions of the Advisers Act are intended as prophylactic means to prevent fraud. In fact, a number of the more important rules under the Advisers Act, including advertising restrictions, custody requirements, and certain disclosure obligations, have been adopted using the authority of section 206(4), which prohibits fraud and gives the Commission the authority to make rules defining fraud and prescribing means reasonably designed to prevent fraud. Determining which of these provisions should have greater or lesser reach would be a difficult and probably fruitless task. We believe that once an investor chooses to deal with a domestic adviser, it would be anomalous to apply only the Advisers Act's antifraud provisions. As discussed in Chapter 6, however, we believe that an exception should be made for section 205's limits on performance fees.

#### **IV. Conclusion**

The Division believes the Advisers Act should be applied more narrowly, based on a conduct and effects analysis. Accordingly, the Division intends to provide no-action advice to investment advisers using this approach. After the Division has had the opportunity to explore the various questions that necessarily will arise, the Division will recommend that the Commission codify that approach.

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<sup>40</sup>See *supra* note 23 and accompanying text. See also **Registration Requirements for Foreign Broker-Dealers, Exchange Act Release No. 25801 at nn.42-44 and accompanying text** (June 14, 1988), 53 FR 23645.

<sup>41</sup>See Sec. Act Rel. 6863, *supra* note 17, at I.

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## Chapter 6

# Performance Based Advisory Compensation

### I. Introduction and Summary of Recommendations

Section 205(a)(1) of the Investment Advisers Act<sup>1</sup> generally prohibits a registered investment adviser from receiving compensation on the basis of a share of capital gains in or capital appreciation of a client's account, or any portion thereof.<sup>2</sup> Commonly referred to as a "performance fee,"<sup>3</sup> this type of compensation arrangement can take various forms. For example, fees equaling ten percent of the gains in an account or of the gains exceeding the performance of a designated securities index or other benchmark are performance fees. Another example of a performance fee is waiver by an adviser of its customary fee unless there is a gain in an account.

The performance fee prohibition was included in the Advisers Act because of Congressional concern that performance fees created incentives for advisers to take inappropriate risks in managing a client's account in order to increase advisory fees.<sup>4</sup> Performance fees in use at the time typically rewarded an adviser, above and beyond its customary fee, for good performance, without penalizing it for poor performance. Congress concluded that performance fees

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<sup>1</sup>Investment Advisers Act of 1940, 15 U.S.C. § 80b.

<sup>2</sup>15 U.S.C. § 80b-5(a)(1). Section 205(a)(1) provides in relevant part:

No investment adviser, unless exempt from registration pursuant to section 203(b), shall make use of the mails or any means or instrumentality of interstate commerce, directly or indirectly, to enter into, extend, or renew an investment advisory contract, or in any way to perform any investment advisory contract entered into, extended, or renewed on or after the effective date of this title, if such contract --

(1) provides for compensation to the investment adviser on the basis of a share of capital gains upon or capital appreciation of the funds or any portion of the funds of the client.

<sup>3</sup>We use the term "performance fee" to refer to those types of compensation arrangements based on capital gains or capital appreciation that are prohibited by section 205(a)(1). Compensation arrangements based on other measures of performance, such as net income, are not prohibited by the Advisers Act.

<sup>4</sup>H.R. REP. No. 2639, 76th Cong., 2d Sess. 29 (1940).

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encouraged advisers to speculate unduly because they had everything to gain and little to lose.

As originally enacted, section 205(a)(1) did not cover contracts between registered investment advisers and investment companies registered under the Investment Company Act.<sup>5</sup> In 1970, however, Congress extended the performance fee prohibition to advisory contracts with registered investment companies based, in part, on information that revealed many registered investment companies had performance-based fee arrangements that allowed their advisers to earn a bonus for good performance without imposing a comparable penalty for poor performance.

At the same time, Congress acknowledged that not all performance fees are inherently undesirable and **exempted** from the performance fee prohibition a type of fee known as a "fulcrum fee."<sup>6</sup> With a fulcrum fee, an adviser's compensation increases or decreases depending on how an account performs relative to an appropriate index or other measure of performance over a specified period.<sup>7</sup> Under the statute, fulcrum fee arrangements may be made only with registered investment companies or persons with whom the adviser has contracted to manage at least \$1 million in assets.

Congress in 1970 also gave the Commission broad authority to exempt, among other things, performance fee arrangements. The Commission exercised its authority in 1985, adopting a rule providing for a second limited exemption from the performance fee prohibition for advisory contracts with wealthy clients having at least \$500,000 under the management of the investment adviser or a net worth exceeding \$1 million, if certain conditions and restrictions contained in the rule are met.<sup>8</sup>

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<sup>5</sup>Investment Company Act of 1940, 15 U.S.C. § 80a.

<sup>6</sup>Advisers Act § 205(b)(2), 15 U.S.C. § 80b-5(b)(2).

<sup>7</sup>Advisers Act rules 205-1 and 205-2 (17 C.F.R. §§ 275.205-1, .205-2) contain requirements regarding how the investment performance of an account and the investment record of an index may be measured and compared.

<sup>8</sup>Investment Advisers Act Release No. 996 (Nov. 14, 1985), 50 FR 48556 (adopting rule 205-3).

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Section 205(a)(1) always has been controversial? Supporters of the prohibition on performance fees point to the potential for excessive risk taking.<sup>11</sup> They believe performance fees may have anti-competitive effects, favoring well-capitalized advisers.<sup>12</sup> They also challenge whether there is any basis, theoretical or actual, for believing that performance fees will improve performance.<sup>13</sup> In addition, some have expressed concern that performance fees would act to the detriment of clients that do not pay performance fees because advisers would devote more of their time and resources to the clients that do.<sup>14</sup>

Critics of the prohibition argue that performance fees are a rational means of compensating advisers because they create a coincidence of advisory and client goals by linking advisory compensation to performance.<sup>15</sup> They assert that performance fees encourage the establishment of new advisory firms and provide an incentive for advisers to service smaller accounts that otherwise would be deprived of advisory services.<sup>16</sup> They also argue that performance fees reduce

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<sup>9</sup>See, e.g., Julie Roher, *The Great Debate Over Performance Fees*, 17 INSTITUTIONAL INVESTOR 123 (Nov. 1983); Richard Grinold and Andrew Rudd, *Incentive Fees: Who Wins? Who Loses?*, 43 FIN. ANALYSTSJ. 27 (Jan.-Feb. 1987); Lawrence K. Davanzo and Stephen L. Nesbitt, *Performance Fees For Investment Management*, 43 FIN. ANALYSTSJ. 14 (Jan.-Feb. 1987); Mark P. Kritzman, *Incentive Fees: Some Problems and Some Solutions*, 43 FIN. ANALYSTSJ. 21 (Jan.-Feb. 1987); Eugene E. Record, Jr. and Mary Ann Tynan, *Incentive Fees: The Basic Issues*, 43 FIN. ANALYSTSJ. 39 (Jan.-Feb. 1987); Laura T. Starks, *Performance Incentive Fees: An Agency Theoretic Approach*, 22 J. FIN. AND QUANTITATIVE ANALYSIS 17 (Mar. 1987); Linda Parham, *Plan Sponsors Cautiously Approach Performance-Based Fees*, 25 PENSION WORLD 24 (June 1989); Charles W. Gregor, *What Are Investment Managers Saying About Performance Based Fees?*, 22 PENSION WORLD 20 (Dec. 1986); HARVEY E. BINES, THE LAW OF INVESTMENT MANAGEMENT ¶ 5.03[2][a] (1978 & Supp. 1986).

<sup>10</sup>Roher, *supra* note 9, at 127.

<sup>11</sup>Grinold & Rudd, *supra* note 9, at 37.

<sup>12</sup>See, e.g., Roher, *supra* note 9, at 128 (noting that incentives for good performance already exist since advisers are compensated on the basis of account size and must perform well in order to retain their clients). See also BINES, *supra* note 9, at 5-36 (indicating that there is no demonstrable connection between performance fees and superior performance).

<sup>13</sup>Letter from the Honorable John D. Dingell, Chairman, House Committee on Energy and Commerce, to John S.R. Shad, Chairman, SEC (Mar. 23, 1983).

<sup>14</sup>Grinold & Rudd, *supra* note 9, at 37. See also BINES, *supra* note 9, ¶5.03[2][b], at 5-43 (observing that the principal justification for performance fees is that they permit the uncertainty in the quality of the product — the management of the portfolio — to be shared between the adviser and the client).

<sup>15</sup>Roher, *supa* note 9, at 124. Critics also argue that performance fees permit advisers to stay smaller than they otherwise would under traditional compensation arrangements because,  
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advisory costs, encourage better performance, and reward good performance.<sup>16</sup> On a practical level, critics charge that clients not needing the protections of the prohibition should be able to structure advisory fees on whatever terms they consider appropriate.

Finally, critics say the prohibition harms domestic advisers<sup>17</sup> when they compete for foreign clients because in many countries performance fee arrangements are not only legal, they are acceptable and customary.<sup>18</sup> Some have suggested that registered advisers be permitted to enter into performance fee contracts with foreign clients to the extent that the laws of a foreign client's home country do not prohibit these fee arrangements.<sup>19</sup>

The Division believes that some of the criticisms of the performance fee prohibition are valid and that modification of the prohibition is warranted. Specifically, we recommend that the Commission transmit to Congress legislation clarifying the Commission's authority under the Advisers Act to exempt from the performance fee prohibition investment advisory contracts with (1) persons whom the Commission determines do not need the protections of the prohibition, based on factors such as wealth and financial sophistication, or (2) persons not residing in the United States, to the extent that performance fees are lawful in the person's country of residence. Although the Commission could expand the existing performance fee exemptive rule to permit certain sophisticated clients of investment advisers to enter into performance fee arrangements, the Division

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<sup>15</sup>(...continued)

assuming an adviser can successfully manage its clients' portfolios, it can generate sufficient income without having to attract a large asset base. *Id.*

<sup>16</sup>BINES, *supra* note 9, at 5-36 to 5-37. Properly drafted performance fees can reduce total management fees during periods of market decline when investors are less willing to pay sizable advisory fees and increase fees during periods of rising returns when investor attitudes are quite different. *Id.*

<sup>17</sup>We use "domestic adviser" to refer to an adviser whose offices and personnel are located in the United States and "foreign adviser" to refer to an adviser whose offices and personnel are located outside the United States.

<sup>18</sup>Commenters responding to the Commission's release regarding the reform of investment company regulation (SEC Request for Comments on Reform of the Regulation of Investment Companies, Investment Company Act Release No. 17534 (June 15, 1990), 55 FR 25322) were particularly concerned about the anti-competitive effects of the prohibition. See, e.g., Letter from Davis Polk & Wardwell to Jonathan G. Katz, Secretary, SEC 40-44 (Oct. 10, 1990), File No. S7-11-90. See also Edward F. Greene, Mitchell S. Dupler, and Alan B. Cohen, *Jurisdictional Reach of the Investment Advisers Act of 1940*, 4 INSIGHTS 21, 24-25, 28 (Oct. 1990).

<sup>19</sup>See, e.g., Stanley B. Judd, *International Investment Advisers*, 19 REV. OF SEC. & COMM. REG. 1, 7 (1986).

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believes it is preferable to obtain from Congress explicit authority to adopt rules effecting the proposed changes?"

This chapter begins with an historical overview of the performance fee prohibition. It then analyzes why broad exemptions from the performance fee prohibition are appropriate for advisory contracts with financially sophisticated clients and foreign clients. Finally, the chapter discusses the recommended legislation.

## II. An Overview of the Performance Fee Prohibition

As originally enacted, the Advisers Act prohibited registered investment advisers from charging performance fees. The prohibition was prompted more by concerns about the inherent nature of performance fees, rather than by evidence of any actual abuse. Congress believed that performance fees encouraged a degree of risk taking by advisers seeking to increase advisory fees.<sup>21</sup> Also, studies indicated that performance fees could induce an investment adviser to advise some clients to buy and others to sell the same securities.<sup>22</sup> In addition, the Code of Professional Practice of the Investment Counsel Association of America expressly prohibited performance fees.<sup>23</sup>

The performance fee prohibition was not absolute. Contracts between investment advisers and investment companies were excluded from the

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<sup>20</sup>The Division believes that, absent statutory amendments, the Commission could not exempt performance fee arrangements with less sophisticated foreign clients.

<sup>21</sup>H.R. REP. NO. 2639, *supra* note 4, at 29; S. REP. NO. 1775, 76th Cong., 3d Sess. 22 (1940). See also SEC, INVESTMENT TRUSTS AND INVESTMENT COMPANIES, H.R. Doc. No. 477, 3d Sess. 30 (1939) [hereinafter INVESTMENT TRUST STUDY] (stating that performance fees encourage advisers to recommend a degree of risk that investors themselves would not knowingly undertake, as advisers have everything to gain and nothing to lose). The INVESTMENT TRUST STUDY found that a number of investment companies paid performance fees, typically 25% of profits, to their investment advisers. INVESTMENT TRUST STUDY, *supra*, at 17. See also TWENTIETH CENTURY FUND, INC., THE SECURITYMARKETS 646 (1935) (citing with disapproval investment advisers who "conduct speculative operations with other people's money for a percentage of the profits without liability for losses").

<sup>22</sup>*Investment Trusts and Investment Companies: Hearings on S. 3580 before a Subcomm. of the Senate Comm. on Banking and Currency*, 76th Cong., 3d Sess., pt. 2, 1004-17 (1940) [hereinafter 1940 Senate Hearings] (referring to findings of the Research Department of the Illinois Legislative Council). In the normal course of the market, some of the accounts receiving advice would profit. Thus, an adviser receiving a performance fee for conflicting advice about the same security would be reasonably assured of profiting from its advice. *Id.* at 1012.

<sup>23</sup>*Id.* at 726 (statement of Dwight C. Rose, President, Investment Counsel Ass'n).

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prohibition.<sup>24</sup> The investment company industry had argued successfully that performance fees closely linked the interests of investors and management throughout the life of the investment and that the basis of compensation should not be specified by statute as long as the chosen basis was disclosed adequately to shareholders.<sup>25</sup>

The industry's position on performance fees was challenged in 1966, when the Commission issued a report that, among other things, recommended that the performance fee prohibition be extended to investment company contracts.<sup>26</sup> Although the report contained no specific examples of abuse, the Commission subsequently furnished Congress with information that, out of 137 registered investment companies with performance fee arrangements, 48 allowed the adviser to earn a bonus for good performance without imposing a penalty for poor performance.<sup>27</sup> An additional 45 investment companies had performance fee arrangements in which the potential rewards were substantially greater than the penalties.<sup>28</sup> Based in part on the Commission's recommendation, bills were introduced in Congress to extend the performance fee prohibition to contracts with investment companies.

Ultimately, in 1970, Congress enacted amendments to the Advisers Act that, among other things, extended the performance fee prohibition to contracts with registered investment companies.<sup>29</sup> At the same time, however, Congress exempted contracts with registered investment companies and certain advisory

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<sup>24</sup>S. 3580, the bill that ultimately became the Investment Company and Advisers Acts, at first included in its declaration of policy a statement that "the national public interest and the interests of investors are adversely affected when advisory compensation is based on profit sharing contracts and other contingent arrangements conducive to excessive speculation and trading." This statement was deleted from the bill as enacted and contracts with investment companies were excluded from the performance fee prohibition.

<sup>25</sup>1940 Senate Hearings, *supra* note 22, at 664,1055.

<sup>26</sup>SEC, REPORT ON THE PUBLIC POLICY IMPLICATIONS OF INVESTMENT COMPANY GROWTH, H.R. REP. NO. 2337, 89th Cong., 2d Sess. 345 (1966).

<sup>27</sup>*Mutual Fund Amendments: Hearings before the Subcommittee on Commerce and Finance of the House Committee on Interstate and Foreign Commerce on H.R. 11995, S. 2224, HR. 13754 and H.R. 14737*, 91st Cong., 1st Sess. 207 (1969).

<sup>28</sup>*Id.*

<sup>29</sup>Investment Company Act Amendments of 1970, Pub. L. No. 91-547, § 25, 84 Stat. 1413 (1970) (codified at 15 U.S.C. § 80b-5(b)(1)).

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accounts in excess of \$1 million that used fulcrum fees?" Congress believed that limiting investment company performance fees to those of the fulcrum variety "would insulate investment company shareholders from arrangements that give investment managers a direct pecuniary interest in pursuing high risk investment policies."<sup>31</sup>

Congress also added section 206A to the Advisers Act, giving the Commission general exemptive authority.<sup>32</sup> In enacting section 206A, Congress expressly contemplated Commission action in appropriate cases "to exempt persons . . . from the ban on performance-based advisory compensation in . . . section [205(a)(1)] of the Advisers Act. . . ."<sup>33</sup>

Thereafter, the Commission issued several orders exempting performance fee arrangements. Generally, the orders applied to contracts with wealthy and financially sophisticated investors, where the advisers made their own substantial investments in the accounts, thus reducing their incentive to take undue risks.<sup>34</sup>

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<sup>30</sup>*Id.* (codified at 15 U.S.C. § 80b-5(b)(2)). This exemption does not apply to accounts organized as trusts, governmental plans, collective trust funds, or separate accounts (essentially, most employee benefit plans).

<sup>31</sup>H.R. REP. NO. 1382, 91st Cong., 2d Sess. 41 (1970); S. REP. NO. 184, 91st Cong., 1st Sess. 45 (1969).

<sup>32</sup>Pub. L. No. 91-547, *supra* note 29, at § 26 (codified at 15 U.S.C. § 80b-6a). Section 206A is substantially similar to section 6(c) of the Investment Company Act (15 U.S.C. § 80a-6(c)). Congress intended this section to give the Commission greater flexibility in administering the Advisers Act. Section 206A provides:

The Commission, by rules and regulations, upon its own motion, or by order upon application, may conditionally or unconditionally exempt any person or transaction or any class or classes or persons, or transactions, from any provision or provisions of this title or of any rule or regulation thereunder, if and to the extent that such exemption is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of this title.

<sup>33</sup>See, e.g., S. REP. NO. 184, *supra* note 31, at 46.

<sup>34</sup>See, e.g., Foster Management Company, Investment Advisers Act Release Nos. 646 (Nov. 1, 1978), 43 FR 52313 (Notice of Application) and 651 (Nov. 28, 1978), 16 SEC Docket 316 (Order); Weiss, Peck & Greer, Investment Advisers Act Release Nos. 623 (Mar. 28, 1978), 43 FR 14193 (Notice of Application) and 625 (Apr. 25, 1978), 14 SEC Docket 946 (Order); Connecticut Mutual Life Ins. Co., Investment Advisers Act Release Nos. 459 (May 7, 1975), 40 FR 20992 (Notice of Application) and 461 (June 5, 1975), 16 SEC Docket 316 (Order).

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The Commission also issued a number of orders exempting advisers to business development companies ("BDCs").<sup>35</sup>

In 1985, the Commission adopted rule **205-3**, establishing a limited performance fee exemption for advisers to certain wealthy clients.<sup>36</sup> The rule sets forth alternative objective tests -- \$500,000 under the adviser's management or a \$1 million net worth -- for measuring a client's eligibility to enter into a performance fee contract. The rule also sets forth two different methods for calculating the compensation paid to an adviser for a given period depending

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<sup>35</sup>BDCs generally invest in small, growing companies whose financing needs cannot be met by the traditional public and institutional financial capital markets. BDC officers and directors usually provide managerial assistance to issuers whose securities are held by the BDC. The developing companies in which the BDC invests typically do not have the funds to compensate the BDC for the efforts of its officers and directors. Therefore, the developing company usually provides compensation in the form of common stock, which, it is hoped, will appreciate in value. Such a compensation arrangement would fall within section 205(a)(1). See generally Reginald L. Thomas & Paul F. Roye, *Regulation of Business Development Companies under the Investment Company Act*, 55 S. CAL. L. REV. 895 (1982). Until 1978, when ~~an~~ adverse court decision (*Abrahamson v. Fletcher*, 568 F.2d 862 (2d Cir. 1977), cert. denied, 436 U.S. 913 (1978)) changed matters, these advisers had relied on an exemption from the registration requirements of the Advisers Act and thus were not subject to the performance fee prohibition. Congress ultimately prescribed special provisions for BDCs. See The Small Business Incentive Investment Act of 1980, Pub. L. No. 96-477, § 203, 94 Stat. 2275 (1980). The legislation, among other things, created a limited exemption from section 205(a)(1) to permit a registered investment adviser to a BDC to receive performance based compensation limited to not more than 20% of the BDC's net realized capital gains. See Advisers Act § 205(b)(3), 15 U.S.C. § 80b-5(b)(3). In the interim, the Commission proposed a rule, rule 205-3, which would have permitted BDC advisers to receive performance fees under certain circumstances. See Investment Advisers Act Release No. 680 (June 19, 1979), 44 FR 37470. The proposed rule would have permitted certain BDC advisers to receive performance fees, provided the BDC's investors were sophisticated and able to bear the economic risk of their investment. Commenters on the proposed rule supported the Commission's efforts to facilitate the flow of capital to small and developing businesses but criticized the rule's restrictive nature. The Commission subsequently withdrew the proposal. Investment Advisers Act Release No. 750 (Feb. 20, 1981), 46 FR 14353.

<sup>36</sup>Inv. Adv. Act Rel. 996, *supra* note ?. The Commission previously had proposed a different version of rule 205-3. That version would have provided general exemptive relief from section 205(a)(1), if the clients were wealthy and knowledgeable and did not need the protections that the prohibition was intended to provide. Investment Advisers Act Release No. 865 (June 10, 1983), 48 FR 2771. The proposal would have required the adviser to find that the client or his representative was sufficiently sophisticated in financial and business matters to understand the merits and risks of the performance fee contract. It also would have required the contract to relate to a minimum of \$150,000 in assets, The Commission later withdrew the proposal. Investment Advisers Act Release No. 911 (May 2, 1984), 49 FR 19524.

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upon the nature of the securities being managed.<sup>37</sup> In addition, the rule requires that any performance fee be based on the gains less the losses in the client's account for a period of not less than one year.<sup>38</sup>

Rule 205-3 also requires an adviser to disclose any potential conflicts of interest that the arrangement may create, the periods which will be used to measure investment performance, the nature and significance of any index that will be used as a comparative measure of investment performance, and the reason the adviser believes the index is appropriate. Where the adviser's compensation is based in part on the unrealized appreciation of securities for which market quotations are not readily available, the adviser is also required to disclose how the securities will be valued and the extent to which the valuation will be independently determined. In essence, the rule places on the adviser the burden of demonstrating that the fee is fair.

### **III. Discussion**

In enacting the statutory exemptions to the performance fee prohibition, Congress has acknowledged that performance fees are appropriate in certain circumstances. Existing exemptions, however, preclude the use of performance fees in advisory contracts in a number of situations, even where the clients are institutions or are otherwise sophisticated. The Division believes that, where a client appreciates the risk of performance fees and is in a position to protect itself from overreaching by the adviser, the determination of whether such fees provide value is best left to the client. The Division also is concerned that the inability of United States investment advisers to enter into performance fee contracts with their foreign clients, even where these arrangements are legal and customary in a client's country of residence, may prevent United States advisers from competing with non-United States advisers in attracting foreign clients. Accordingly, the Division believes that additional exemptions from the performance fee prohibition are warranted.

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<sup>37</sup>For securities for which market quotations are readily available, the formula must include realized capital losses and unrealized capital depreciation of the securities over the period. For securities for which market quotations are not readily available, the formula still must include realized capital losses, but need not include unrealized capital depreciation unless it also includes unrealized capital appreciation. 17 CFR. § 205-3(c).

<sup>38</sup>Advisers may use any method for receiving payment of the performance fee, but it must be consistently applied and fully disclosed to clients. For example, the fee could be paid annually after each year's performance or the fee could be paid on a rolling basis beginning at the end of a year's performance. Regardless of the method chosen, no part of a performance fee may be paid for any period of less than one year. See Inv. Adv. Act Rel. 996, supra note ?, at n.14.

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### A. Financially Sophisticated Clients

Neither of the two limited performance fee exemptions available for advisory contracts with financially sophisticated clients is sufficiently flexible to permit advisers to enter into unconditional performance fee arrangements with those clients. Advisers relying on the fulcrum fee exemption must structure their performance fee arrangements to increase and decrease proportionately. Many institutional investors, however, prefer to structure performance fee arrangements with a low base fee, with satisfactory performance resulting in additional compensation. Such a fee does not qualify as a fulcrum fee.

Rule 205-3 provides an alternative for sophisticated investors that do not wish to use a fulcrum fee arrangement. Rule 205-3 contains a number of conditions that, while they are intended to protect investors and might well be insisted upon by a sophisticated client, preclude the use of certain types of performance fee arrangements. For example, some clients may wish to employ performance fees in short-term investment situations (e.g., less than one year). Or, in cases where market quotations are not readily available, clients may wish to exclude realized capital losses or unrealized capital depreciation (even if unrealized capital appreciation is included) from performance fee calculations. Rule 205-3 prohibits either of these situations no matter how sophisticated the client.

Advisory clients that are financially sophisticated, or have the resources to obtain sophisticated financial advice, and that can negotiate fee arrangements on an arm's length basis should be permitted to employ performance fees on terms they consider appropriate. In these instances, we believe that such clients can take steps to protect themselves against overreaching by an adviser.<sup>39</sup>

### B. Foreign Clients

Historically, the Division has taken the position that the Advisers Act applies to all activities of foreign advisers registered under the Act. One consequence of this position is that, unless a foreign adviser establishes an "independent" affiliate registered under the Advisers Act in accordance with conditions set forth by the Division, the adviser is subject to the performance fee prohibition with respect to its foreign clients as well as its United States clients. As discussed in Chapter 5, the Division now believes that the Commission should employ a "conduct" and "effects" approach to the application of the Advisers Act. Under that approach, the Advisers Act's provisions, including the performance

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<sup>39</sup>Of course, advisers entering into performance fee arrangements with sophisticated clients would continue to be subject to the antifraud prohibitions of Advisers Act section 206 (15 U.S.C. § 80b-6).

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fee prohibition, generally would not apply to a foreign adviser's dealings with non-United States clients. The dealings of domestic advisers with foreign clients, however, would remain subject to the Advisers Act. Thus, without further modifications, domestic advisers still would be restricted in charging performance fees to foreign clients, even where performance fees are legal and customary in the client's country of residence.

Many foreign countries do not restrict the use of performance fees by advisers.<sup>40</sup> In countries where performance fees are an accepted practice, foreign advisory clients may be discouraged from employing domestic advisers because those advisers only may enter into performance fee arrangements that meet the requirements of one of the two available exemptions. These limitations likely reduce the ability of domestic advisers to compete effectively with foreign advisers in foreign markets.

The Division has concluded that domestic advisers should be permitted to enter into performance fee contracts with foreign clients on terms that are lawful in a given client's country of residence. While the Commission has a strong interest in regulating the conduct of investment advisers resident in the United States to ensure that our shores do not become a base for the export of fraud, the Commission's interest in restricting the use by domestic advisers of performance fee contracts with their foreign clients is less compelling given the limited purposes of section 205(a)(1). Indeed, Congress has acknowledged that performance fees are not inherently fraudulent.

Of course, a foreign client may choose a domestic adviser precisely because the adviser is subject to United States regulatory requirements, including the performance fee prohibition. In that case, the foreign client would be free to refuse to contract for advisory services on a performance fee basis. If a domestic adviser were to impose a performance fee contract on a foreign client in a misleading manner (*e.g.*, either the client was unaware he was entering into a performance fee contract, or was misled as to the nature of the fee arrangement), the adviser's conduct would continue to be subject to the antifraud prohibitions of Advisers Act section 206.

#### **IV. Recommendations**

We recommend legislation authorizing the Commission generally to provide exemptions from the performance fee prohibition for advisory contracts

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<sup>40</sup>See, *e.g.*, Rule 5 of the Rules of the Investment Management Regulatory Organization Limited. See also Debevoise & Plimpton, *International Survey of Investment Adviser Regulation* (Aug. 1990) (providing analyses of the investment advisory laws of Australia, Brazil, France, Germany, Japan, Switzerland, and the United Kingdom).

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with (1) any person whom the Commission determines does not need the protections of the prohibition and (2) foreign clients, to the extent that performance fees are lawful in the client’s country of residence.<sup>41</sup> Although the Commission probably could use its section 206A authority to provide further exemptions from the performance fee prohibition for advisory contracts with sophisticated investors, absent specific legislative authority the Commission could not provide performance fee exemptions for advisory contracts with less sophisticated foreign clients. Therefore, because the Commission will need Congressional authority to institute a foreign client exemption, we suggest that Congress, at the same time, clarify through legislation the Commission’s ability to provide unconditional exemptions for advisory contracts with sophisticated investors.

Under the proposed legislation, the Commission could adopt a rule permitting United States advisers to enter into performance fee arrangements with their foreign clients to the extent those arrangements were lawful in the client’s country of residence.<sup>42</sup> The Division would expect to recommend a rule under this authority that would place on the adviser the burden of determining whether and to what extent the law of a foreign country permits the use of performance fees by advisers resident within that jurisdiction.<sup>43</sup> The rule would provide that violations of a foreign country’s law by an adviser with respect to performance fees would result in the adviser’s loss of the exemption and, absent the availability of another exemption, a violation of section 205(a)(1). We also would expect to recommend that United States advisers be required to keep records regarding their performance fee contracts with foreign clients to enable the Commission to monitor these activities through its inspection program.

The legislation would not establish specific eligibility requirements for persons with whom an adviser may contract for performance fees; instead the Commission would set those requirements by rule. This approach will provide more flexibility in administering the exemptions. Writing directly into the statute an unconditional sophisticated client exemption based solely on a financial means test would require the Commission to seek statutory amendments if the monetary level chosen became anachronistic. Similarly, writing a foreign client exemption directly into the statute would, absent statutory amendments, preclude Commission revision or rescission of the exemption if problems arose. In addition, the specific criteria for identifying sophisticated advisory clients not

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<sup>41</sup>The recommended statutory language appears in Appendix 6-A at the end of this chapter.

<sup>42</sup>As discussed previously, these advisers’ activities would continue to be subject to the antifraud provisions of Advisers Act section 206.

<sup>43</sup>Placing this burden on advisers would mean that the Commission would not have to commit substantial resources to make these determinations on a case-by-case basis.

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requiring the protections of a prohibition on performance fees may be subject to debate, as may be the exact terms of an exemption for foreign clients.

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## APPENDIX 6-A

### Red-Lined Version of Proposed Amendment to the Investment Advisers Act of 1940

(new language is shaded; deleted language is struck through)

#### Section 205 [15 U.S.C. § 80b-5].

\* \* \*

(e) The Commission, by rules and regulations, upon its own motion, or by order upon application, may conditionally or unconditionally exempt any person or transaction, or any class or classes of persons or transactions, from paragraph (1) of subsection (a) if and to the extent the exemption relates to an investment advisory contract with (i) any person whom the Commission shall have determined does not need the protections of paragraph (1) of subsection (a) on the basis of such factors as financial sophistication, net worth, knowledge and experience in financial matters, amount of assets under management, relationship with a registered investment adviser, or such other factors as the Commission may determine are consistent with the intent of this provision, or (ii) a person who is not a resident of the United States, provided the exemption is consistent with the laws of the person's country of residence.

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## Chapter 7

# Investment Company Governance

### I. Introduction and Summary of Recommendations

The age-old question, "who ~~will~~ watch the watchmen?", is of particular relevance to the present-day investment company industry. Twenty-five percent of American households entrust their accumulated savings and investment funds to investment company sponsors and managers.<sup>1</sup> Total investment in management investment companies exceeded \$1.34 trillion as of December 31, 1991.<sup>2</sup> As evidenced by the recent episodes of mismanagement and abuse that have beset other financial intermediaries, the need for effective oversight of these entities is crucial.

The task of providing such protection is a difficult one. Investment companies are unique in that they are organized and **operated by people whose primary loyalty and pecuniary interest lie outside the enterprise.**<sup>3</sup> Consequently, conflicts of interest inhere in the structure of companies, creating great potential for abuse.

Congress recognized this when it enacted the Investment Company Act,<sup>4</sup> a statute whose purpose was to eliminate the pervasive abuses that occurred in the investment company industry prior to 1940. To correct these abuses, and police the conflicts of interest that engendered them, the Act

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<sup>1</sup>INVESTMENT COMPANY INSTITUTE, 1990 MUTUAL FUND FACT BOOK 66 (30th ed. 1990). The Institute estimates that there are over 62 million shareholder accounts in mutual funds. INVESTMENT COMPANY INSTITUTE, 1991 MUTUAL FUND FACT BOOK 75 (31st ed. 1991).

<sup>2</sup>Investment Company Institute News Release, ICI-92-03 (Jan. 29, 1992); Lipper Analytical Services Closed End Fund Performance Analysis Service 44 (Jan. 31, 1992). This figure does not include monies invested in unit investment trusts and variable insurance products.

<sup>3</sup>The typical investment company is organized by an outside "sponsor." The sponsor may be a broker-dealer, investment advisory firm, insurance company, or bank. All services necessary to market and operate the company, including investment advisory, administration, and distribution services, are provided by the sponsor, its affiliates, or outside contractors. Although investment companies have officers, they usually are employed and compensated by the sponsor. Thus, an investment company has no employees that are truly its own.

<sup>4</sup>Investment Company Act of 1940, 15 U.S.C. § 80a.

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establishes a comprehensive regulatory framework predicated upon principles of corporate democracy.

Although the Act does not explicitly require that investment companies be organized in corporate form; it imposes requirements that assume the standard equipment of a corporate democracy: a board of directors (forty percent of whom must be independent): whose function is to oversee the operations of the investment company and police conflicts of interest; and shareholder voting to, among other things, elect board members, approve or disapprove fee arrangements, and accept or reject changes in a company's investment policies. These requirements apply even to investment companies that are not corporations but are organized in some other form such as a business trust or limited partnership.

Over the years, commentators have expressed skepticism about the effectiveness of boards of directors and the value of shareholder voting for investment companies. Some have argued that boards of directors are not effective monitors of the sponsor. Others have observed that boards of directors increasingly are called upon to micro-manage the day-to-day affairs of the investment company to the detriment of the board's traditional oversight function. A third group has asserted that investment company shareholder voting is perfunctory and that costs incurred in complying with shareholder voting requirements outweigh any benefits to shareholders. While some commentators have called for improvements to current governance arrangements, others have advocated alternative governance arrangements embodied in proposals such as

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<sup>5</sup>Indeed, the definition of an "investment company" includes entities organized in any form whatsoever. See sections 3(a), 2(a)(22), and 2(a)(8), 15 U.S.C. §§ 80a-3(a), -2(a)(22), and -2(a)(8) (definitions of "investment company," "issuer," and "company," respectively).

<sup>6</sup>Section 10(a), 15 U.S.C. § 80a-10(a), requires that at least 40% of the board of directors of a registered investment company consist of individuals who are not "interested persons," as defined in section 2(a)(19), 15 U.S.C. § 80a-2(a)(19). We refer to such individuals as "independent directors."

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the unitary investment fund ("UIF")<sup>7</sup> as a way of streamlining investment company governance requirements and reducing operating costs.<sup>8</sup>

The Division has reexamined the adequacy of the governance structure for investment companies. Our purpose was to analyze whether changes could be made to the existing structure that would increase the effectiveness of boards of directors in monitoring conflicts of interest, provide shareholders with more meaningful voting opportunities, and reduce investment company expenses, without sacrificing investor protections. The Division has also considered the feasibility and desirability of permitting alternative organizational forms like the UIF as a means to streamline governance requirements and reduce expenses.

The Division has concluded that the governance model embodied in the Act is sound and should be retained, with limited modifications. The oversight function performed by investment company boards of directors, especially the "watchdog" function performed by the independent directors, has served investors well, at minimal cost. In our view, however, the increasingly significant responsibilities placed on independent directors warrant a few changes to further strengthen their independence. Accordingly, the Division recommends that the Commission recommend legislation that would increase the minimum proportion of independent directors on investment company boards from forty percent to more than fifty percent. In addition, the Division recommends that independent

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<sup>7</sup>The UIF, originally proposed over 10 years ago, would be an alternative form of investment company similar to a trust. The UIF would have no board of directors and no shareholder voting. A contract between the investment manager and the fund would set forth investment objectives, fees, and charges to shareholder accounts. A single management fee would cover all expenses, except for extraordinary expenses and shareholder account services. The contract could be amended after a period of time, but only with notice to investors. Section IV, infra, discusses the UIF concept in greater detail.

<sup>8</sup>In the SEC's Request for Comments on Reform of the Regulation of Investment Companies, Investment Company Act Release No. 17534 (June 15, 1990), 55 FR 25322 [hereinafter Study Release], the Commission specifically requested comment on whether management open-end investment companies should be allowed to operate as UIFs. A number of commenters addressed the UIF proposal, including Benham Capital Management Group; Francis X. Cain; Calvert Group, Ltd.; Debevoise & Plimpton (on behalf of the independent directors of the Fidelity Investment Company complex); Dechert Price & Rhoads; Federated Investors; Fidelity Management & Research Co.; Tamar Frankel; Michael I. Freedman; S. Green Research Associates, Inc.; K. C. Gupta; Hale and Dorr; IDS Mutual Fund Group; Institutional Shareholder Services, Inc.; The Investment Company Institute; Lipper Analytical Services, Inc.; members of the Business and Corporations Law section of the Los Angeles County Bar Association; R. Bruce Oliver; Prudential Mutual Fund Management, Inc.; Putnam Management Company, Inc.; Ropes and Gray; Scudder, Stevens and Clark, Inc. ("Scudder"); the independent trustees of investment companies managed by Scudder; The Vanguard Group, Inc.; Kathleen A. Veach; and Warburg Investment Management International Ltd. Other commenters addressed issues relating to governance requirements but did not mention the UIF.

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director vacancies be filled by persons chosen by remaining independent directors. Finally, the Division proposes that independent directors be given the express authority to terminate advisory contracts.

At the same time, however, the Division recommends eliminating provisions in certain rules under the Act that make independent directors responsible for detailed findings of fact or for reviews and findings that involve more ritual than substance. Elimination of such formalistic requirements will increase the effectiveness of boards of directors by allowing them to focus to a greater extent on what they do best -- exercising business judgment in their review of interested party transactions and in their oversight of operational matters where the interests of an investment company and its adviser may diverge.

The Division also has concluded that while shareholder voting continues to have a valuable communicative and deterrent function in investment company regulation -- particularly where redemption is not cost free -- several voting requirements under the Act do not comport with the realities of modern securities markets and can no longer be justified on an investor protection basis. The Division consequently recommends the elimination or modification of a number of these requirements. In particular, the Division recommends that investment company shareholders no longer be required to ratify the initial advisory contract and rule 12b-1 plan (if any) of a newly organized company, concur in the board's selection of auditors, or approve changes in relatively routine investment policies.

Conversely, the Division recommends that other voting requirements relating to proposals that could significantly alter the nature of an investor's investment (*e.g.*, changes in investment advisory contracts and amendments to rule 12b-1 plans that materially increase the amount spent on distribution) be retained. In addition, because we believe that an investment company's investment objective is a critical determinant of the potential risk and reward inherent in the shareholder's investment, we recommend that the Act be amended to add an explicit requirement that shareholders approve any change in investment objective.

Finally, the Division has concluded that a contractual or UIF structure is fundamentally incompatible with the regulatory philosophy of the Act, which relies on boards of directors to monitor investment company operations and resolve conflicts of interest. In our view, implementation of the UIF concept

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would require a wholesale restructuring of existing regulatory arrangements, with little or no apparent benefit for investors?

This chapter begins with a description of the Act's governance requirements, and how they address the conflicts of interest inherent in investment companies. We then discuss the most significant issues raised by both critics and proponents of the current governance system and set forth recommendations for reform that we believe will improve investment company governance without sacrificing investor protection. Finally, we analyze the feasibility and desirability of the UIF as an alternative investment vehicle.

## **II. Conflicts of Interest and Investment Company Governance under the Act**

Unlike the typical corporation, virtually all registered investment companies are organized and operated by an "outsider," usually a separate corporate entity with its own public shareholders. In such an arrangement, there is obvious potential for conflict between the interests of investment company sponsors and managers and the interests of investment company shareholders.

To address those situations in which interests conflict, the Act establishes a comprehensive regulatory framework premised on the checks and balances of governance. The Act imposes watchdog and other responsibilities on boards of directors, grants shareholders voting rights with respect to particular matters, and authorizes shareholders to seek judicial review of certain fee arrangements.

### **A. The Role of the Board of Directors**

The role of directors in policing conflicts of interest is central to the Act.<sup>10</sup> The independent directors, in particular, are expected to look after the interests

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<sup>9</sup>As described in Chapter 8, however, we recommend, as an alternative to the UIF, the unified fee investment company ("UFIC"). The UFIC, which would be an optional form of investment company, would have a streamlined fee structure similar to that of the UIF, but would retain directors to monitor operational conflicts of interest. Shareholder voting would be reduced.

<sup>10</sup>The duties imposed on directors by the Act are in addition to those imposed by state law. Under state law, for example, the role of the board of directors of a public corporation is to provide management direction to the corporation, to approve major transactions, and to exercise particular oversight as to matters involving conflicts of interest of management. Directors are typically bound, under statutes and case law, by duties of loyalty and care. The duty of loyalty prohibits a director from taking advantage of a corporation and its shareholders. The duty of care requires that a director exercise the degree of skill, diligence, and care that a reasonably prudent person would exercise in the same circumstances or in the management of his own affairs.

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of shareholders by "furnishing an independent check upon management,"<sup>11</sup> especially with respect to fees paid to the investment company's sponsor.

As we discuss in greater detail below, a number of provisions of the Act and rules thereunder rely on boards of directors to protect investment company shareholders in conflict of interest situations. The board has primary responsibility under the Act for evaluating the reasonableness of a number of different, and in some cases overlapping, fees and charges for investment advice, distribution, administration, and shareholder services. The Act and its rules also make the board responsible for policing various operational conflicts, and give the board the authority to permit various types of transactions to go forward without prior Commission review of individual exemptive applications.

### **1. Board Evaluation of Fees Paid to Sponsors and their Affiliates**

Fees paid from an investment company's assets to sponsors and their affiliates -- whether advisers' fees, principal underwriting fees, distribution fees, or fees for other services -- directly affect shareholders' investment return. The higher the fee, the lower the return. The conflict of interest is inherent.<sup>12</sup>

To ensure the reasonableness of fees paid to investment company sponsors and others for services provided to a company, the Act imposes varying requirements, depending on the type of fee involved. In certain cases, the Act requires the board of directors to evaluate the reasonableness of a particular fee. In other cases, the Act requires a multilayered review process that includes not only evaluation by the board but also shareholder approval and the opportunity for judicial review. The Act does not require the board to review all fees, however.

For advisory fees, sections 15(a) and 15(c)<sup>13</sup> charge the board of directors with the responsibility for evaluating the adviser's contract with the investment

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<sup>11</sup>Burks v. Lasker, 441 U.S. 471,484 (1979).

<sup>12</sup>Related conflicts may arise in connection with dividing the benefits of any economies of scale that may be generated as the assets of the company increase. Advisory fees typically are calculated as a percentage of assets under management, although the cost of providing investment advisory services -- consisting largely of salaries and overhead -- is relatively fixed (*i.e.*, a portfolio manager can manage \$500 million nearly as easily as \$100 million). An advisory fee that does not scale down as company assets increase consequently may yield enormous profits to the adviser, to the detriment of shareholders.

<sup>13</sup>15 U.S.C. §§ 80a-15(a), -15(c).

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company and the compensation paid under the contract.<sup>14</sup> The independent directors must separately evaluate and approve the advisory contract and any renewals of such contracts. Advisory contracts continuing in effect for a period of more than two years must be approved annually by either the full board or a majority of the company's outstanding shares.<sup>15</sup> The full board has the authority to terminate the advisory contract at any time, but such authority is not expressly given to the independent directors.<sup>16</sup>

Principal underwriting contracts are subject to similar board scrutiny. Such contracts and any renewals must be evaluated and approved by the independent directors.<sup>17</sup> Multiyear contracts also must be approved annually by the board or by a majority shareholder vote.<sup>18</sup>

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<sup>14</sup>When section 15 was enacted in 1940, Congress and the Commission were not concerned with the magnitude of advisory fees. David Schenker, after discussing certain state laws that limited management and operating expenses to a percentage of assets, testified that:

There is not a single provision in section 15 which even remotely assumes to fix what [advisers] should be paid in compensation . . . . We feel that is a question for the stockholders to decide. If they want to pay a man a million dollars to manage the fund and if they know they are paying him a million dollars and if they have the right to approve the payment of a million dollars, the bill says that is perfectly all right.

*Investment Trusts and Investment Companies: Hearings on S. 3580 before a Subcomm. of the Senate Comm. on Banking and Currency*, 76th Cong., 3d Sess. 252 (1940) (statement of David Schenker, Chief Counsel, SEC Investment Trust Study). In the 1960's, the Commission began to examine the level of advisory fees. See SEC, REPORT ON THE PUBLIC POLICY IMPLICATIONS OF INVESTMENT COMPANY GROWTH, H.R. Rep. No. 2337, 89th Cong., 2d. Sess. 10-12, 69, 102-21, 126-27 (1966) [hereinafter PPI REPORT]. See also WHARTON SCHOOL OF FINANCE AND COMMERCE, A STUDY OF MUTUAL FUNDS, H.R. Rep. No. 2274, 87th Cong., 2d Sess. 491-95 (1962) [hereinafter WHARTON REPORT]. The Commission concluded that the unique nature of the mutual fund industry made arms length bargaining impossible, that the marketplace consequently could not be relied upon to curb excessive fees, and that existing law did not adequately protect investors with respect to such fees. PPI REPORT at 12-13. The Commission thereafter recommended that the Act be amended to include a "reasonableness" standard for fees. This standard, however, was never adopted. In 1970, Congress enacted section 36(b) (15 U.S.C. § 80a-35(b)), which imposes a fiduciary duty on advisers with respect to the amount of compensation received. See *infra* notes 55-58 and accompanying text. Congress also enacted current section 15(c), which strengthened the ability of directors to carry out their responsibility for scrutinizing advisory contracts. Investment Company Act Amendments of 1970, Pub. L. No. 91-547, 84 Stat. 1413 (1970).

<sup>15</sup>Section 15(a)(2), 15 U.S.C. § 80a-15(a)(2).

<sup>16</sup>Section 15(a)(3), 15 U.S.C. § 80a-15(a)(3).

<sup>17</sup>Section 15(c), 15 U.S.C. § 80a-15(c).

<sup>18</sup>Section 15(b)(1), 15 U.S.C. § 80a-15(b)(1).

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The board also is required to review and evaluate asset-based distribution fees. Rule 12b-1<sup>19</sup> permits open-end companies to use fund assets to pay for distribution expenses under a plan ("rule 12b-1 plan") approved and monitored by the directors. Rule 12b-1 plans, and any material amendments to the plan, must be approved by both the full board and the independent directors.<sup>20</sup> The independent directors also are empowered by rule 12b-1 to terminate the plan and any agreement related to the plan at any time.<sup>21</sup>

Contracts covering ancillary services such as transfer agency, shareholder accounting, and custodial arrangements are not subject to express director or shareholder approval requirements under the Act.<sup>22</sup> Because service contracts with affiliates of the adviser are within the plain language of section 36(b),<sup>23</sup> an investment company's board of directors likely would review any service contract between the company and the adviser's affiliates.<sup>24</sup>

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<sup>19</sup>17 C.F.R. § 270.12b-1.

<sup>20</sup>Rule 12b-1(b)(2), -(b)(4), 17 C.F.R. §§ 270.12b-1(b)(2), .12b-1(b)(4).

<sup>21</sup>Rule 12b-1(b)(3)(iii), -(b)(3)(iv)(A), 17 C.F.R. §§ 270.12b-1(b)(3)(iii), .12b-1(b)(3)(iv)(A).

<sup>22</sup>In the 1970's, the Commission considered whether some service contracts involving affiliates were joint transactions under section 17(d) and rule 17d-1. Notice of Proposal to Amend Rule 17d-1 under the Investment Company Act of 1940 to Provide an Exemption from the Rule for Affiliated Persons with Respect to Certain Service Agreements with Investment Companies, Investment Company Act Release No. 8245 (Feb. 25, 1974), 39 FR 8935 (proposing conditional exemption from rule 17d-1). The Commission proposed that independent directors review administrative contracts in the same manner required for advisory contracts under section 15(c). The issue was never definitively resolved. See Investment Company Contracts for Services with Affiliated Persons; Withdrawal of Proposed Rule Amendment, Investment Company Act Release No. 10822 (Aug. 8, 1979), 44 FR 47546 (withdrawing proposal). The Division has issued a number of no-action letters under sections 17(a) and 17(d) and rule 17d-1 on service contracts involving affiliates. See, e.g., Merrill Lynch Capital Fund, Inc. (pub. avail. Dec. 21, 1990).

<sup>23</sup>See infra notes 55-58 and accompanying text.

<sup>24</sup>Increasingly, large investment company complexes are contracting with investment adviser affiliates for ancillary services. The need for board scrutiny and approval of such contracts is plain, especially when one considers that service fees may greatly exceed advisory fees. For example, during its 1991 fiscal year, the Prime Portfolio of Vanguard Money Market Reserves paid \$837,000 for investment advisory services, \$10.86 million for administration and operations, and \$21.93 million for shareholder account maintenance. Vanguard Money Market Reserves, 1991 Annual Report.

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## **2. Board Responsibilities Related to Operational Conflicts**

In addition to policing conflicts over fees paid to affiliates, investment company boards of directors also police a number of operational activities, some of which involve potentially serious conflicts.

The Act and the Commission's rules give independent directors several specific responsibilities in this regard. For example, the independent directors select the company's independent public accountants,<sup>25</sup> oversee securities transactions involving affiliates to the extent such transactions are permitted by various rules,<sup>26</sup> determine annually whether participation in joint liability insurance policies is in the best interests of the company,<sup>27</sup> and review and approve fidelity bonds.<sup>28</sup> They are also required to select and nominate individuals to fill independent director vacancies for a period of three years following the sale of an investment advisory contract.<sup>29</sup>

In other cases, the full board must approve operational activities.<sup>30</sup> For example, the full board values certain types of portfolio securities<sup>31</sup> and sets the time of day at which net asset value is determined.<sup>32</sup> With respect to a proposed merger of two or more investment companies in the same complex, the board must determine that participation is in the best interest of the company and that the interests of shareholders will not be diluted.<sup>33</sup> The board annually

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<sup>25</sup>Section 32(a)(1), 15 U.S.C § 80a-31(a)(1).

<sup>26</sup>*See, e.g.*, sections 10(f), 17(a), 17(e), 15 U.S.C §§ 80a-10(f), -17(a), -17(e), and rules 10f-3, 17a-7, 17e-1, 17 C.F.R. §§ 270.10f-3, .17a-7, .17e-1.

<sup>27</sup>Rule 17d-1(d)(7), 17 C.F.R. § 270.17d-1(d)(7).

<sup>28</sup>Rule 17g-1, 17 C.F.R. § 270.17g-1.

<sup>29</sup>Section 16(b), 15 U.S.C § 80a-16(b).

<sup>30</sup>In addition to the operational responsibilities described in the text, the full board has concurrent responsibility with the independent directors with respect to the required oversight of affiliated transactions under rules 10f-3, 17a-7, and 17e-1, and in making determinations concerning joint liability insurance under rule 17d-1(d)(7).

<sup>31</sup>Under section 2(a)(41) (15 U.S.C. § 80a-2(a)(41)), and rule 2a-4 (17 C.F.R. § 270.2a-4), the directors are responsible for valuing portfolio securities and other assets for which market quotations are not readily available. Rule 2a-7 (17 C.F.R. § 270.2a-7) requires money market fund directors to monitor both the valuation process and the credit quality of portfolio securities.

<sup>32</sup>Rule 22c-1(b), 17 C.F.R. § 270.22c-1(b).

<sup>33</sup>Rule 17a-8, 17 C.F.R. § 270.17a-8.

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approves custody contracts with members of national securities exchanges, clearing agencies or book-entry systems, and foreign custodians.<sup>34</sup> It also makes determinations of credit quality with respect to investments in debt securities of issuers deriving more than fifteen percent of their revenues from securities-related activities.<sup>35</sup> Finally, the board approves an investment company's code of ethics, which must be designed to prevent fraudulent, deceptive, or manipulative practices by investment company insiders in connection with personal securities transactions.<sup>36</sup>

## B. The Role of Shareholders

As an additional safeguard against self-dealing by the investment adviser and underwriter, the Act accords voting powers to investment company shareholders beyond those required by state corporate law. Section 18<sup>37</sup> requires that, with limited exceptions, every share of investment company stock must "be voting stock and have equal voting rights with every other outstanding voting stock."<sup>38</sup> As we discuss below, the Act and the rules thereunder also provide shareholders with specific voting rights and impose shareholder approval requirements in three general areas: imposition of fees, selection of shareholder representatives, and changes in an investment company's investment policies. Shareholder voting generally is not used to police operational conflicts.

### 1. Shareholder Voting on Fees

Advisory contracts and rule 12b-1 distribution plans must be approved initially by a majority of the investment company's voting shares.<sup>39</sup> Subsequent changes to the advisory contract, and amendments to the rule 12b-1 plan that

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<sup>34</sup>Rules 17f-1, 17f-4, and 17f-5, 17 C.F.R. §§ 270.17f-1, .17f-4, .17f-5.

<sup>35</sup>Rule 12d3-1(b)(5), 17 C.F.R. § 270.12d3-1(b)(5).

<sup>36</sup>Rule 17j-1, 17 C.F.R. § 270.17j-1.

<sup>37</sup>15 U.S.C. § 80a-18.

<sup>38</sup>Section 18(i), 15 U.S.C. § 80a-18(i). The primary exception is for investment companies organized in series, with each series representing interests in a single portfolio of securities. Section 18(f)(2), 15 U.S.C. § 80a-18(f)(2).

<sup>39</sup>Section 15(a), 15 U.S.C. § 80a-15(a), and rule 12b-1(b)(1), 17 C.F.R. § 270.12b-1(b)(1). Shareholders are also required, under section 15(a)(3) and 15(a)(4) respectively, to approve a new advisory contract following the board's termination of an advisory contract and to approve any assignment of the advisory contract. Under rule 15a-4, this vote must occur within 120 days after the board termination or the assignment. 17 C.F.R. § 270.15a-4. Shareholders, by a majority vote, also may terminate the advisory contract on their own accord. Section 15(a)(3).

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would materially increase the amount spent for distribution, also must be approved by shareholders!<sup>40</sup>

## **2. Shareholder Voting on the Election of Shareholder Representatives**

The Act requires that shareholders elect a board of directors. Section 16(a) generally prohibits any person from serving as a director of a registered investment company unless elected by a majority of the investment company's voting shares. An exception to this requirement, however, permits vacancies in the board to be filled in "any otherwise legal manner" if, after the vacancy is filled, at least two-thirds of the directors are shareholder-elected.<sup>41</sup> In addition, under section 16(b), shareholders are required, with certain exceptions, to elect independent directors for a period of three years following the assignment of an investment advisory contract, if the vacancy occurs in connection with the adviser's reliance on the safe harbor provided by section 15(f)(1)(A).<sup>42</sup>

Shareholders also are required to ratify the selection of public accountants previously made by the independent directors, but only if an annual meeting of shareholders is held.<sup>43</sup> If no annual meeting is held, the selection of auditors is left to the discretion of the independent directors.

## **3. Shareholder Voting on Changes in Investment Company Investment Policies**

Taken together, sections 8(b)<sup>44</sup> and 13(a)<sup>45</sup> effectively require an investment company to adopt fundamental policies with respect to certain key

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<sup>40</sup>Section 15(a), 15 U.S.C. § 80a-15(a), and rule 12b-1(b)(4), 17 C.F.R. § 270.12b-1(b)(4). In addition, either shareholders or the board must annually approve multiyear advisory and principal underwriting contracts. Sections 15(a), (b). Typically, the board approves such contracts, rather than shareholders.

<sup>41</sup>Section 16(a), 15 U.S.C. § 80a-16(a).

<sup>42</sup>Section 15(f)(1)(A) permits an investment adviser to receive compensation for the assignment of an investment company's advisory contract if, among other things, 75% of the board is comprised of independent directors for three years following the assignment of an investment advisory contract. 15 U.S.C. § 80a-15(f)(1)(a).

<sup>43</sup>Section 32(a)(2), 15 U.S.C. § 80a-31(a)(2).

<sup>44</sup>15 U.S.C. § 80a-8(b).

<sup>45</sup>15 U.S.C. § 80a-13(a).

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investment activities, which policies are changeable only by shareholder vote.<sup>46</sup> Section 8(b) requires an investment company to file a registration statement with the Commission reciting, among other things, its policies as to classification and subclassification under the Act, borrowing money, issuance of senior securities, engaging in the business of underwriting, concentration, purchase and sale of real estate and commodities, making loans to other persons, and portfolio turnover.<sup>47</sup> The company also must recite all investment policies that are changeable only by shareholder vote<sup>48</sup> and all policies the company deems fundamental.<sup>49</sup>

Section 13 complements section 8(b) by prohibiting an investment company from changing investment and other policies absent a shareholder vote. It requires shareholder approval where a company: (1) changes its subclassification as an open-end or closed-end company or changes from a diversified to a non-diversified company;<sup>50</sup> (2) borrows money, issues senior securities, underwrites securities issued by others, purchases or sells real estate or commodities, or makes loans to other persons, except as stated in the recital of policy set forth in the company's registration statement;<sup>51</sup> (3) deviates from the concentration policy set forth in its registration statement;<sup>52</sup> (4) deviates from any investment policy that is changeable only by shareholder vote or that is a fundamental policy under section 8(b)(3);<sup>53</sup> or (5) changes the nature of its business so as to cease being an investment company.<sup>54</sup>

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<sup>46</sup>In general, the activities that must be governed by a fundamental investment policy deal with those elements of capital structure, permissible investments, and investment strategies that significantly affect the investment characteristics and the risk-reward profile of the securities issued by an investment company. The fundamental policy requirements of the Act have remained unchanged for 50 years, although there has been a steady accretion of Commission and Division interpretations of their applicability to new investment instruments and techniques.

<sup>47</sup>Section 8(b)(1). Each recital of policy must contain a statement as to whether the registrant reserves freedom of action to engage in such activities, and, if so, the intended extent of that engagement. *Id.*

<sup>48</sup>Section 8(b)(2), 15 U.S.C. § 80a-8(b)(2).

<sup>49</sup>Section 8(b)(3), 15 U.S.C. § 80a-8(b)(3).

<sup>50</sup>Section 13(a)(1), 15 U.S.C. § 80a-13(a)(1).

<sup>51</sup>Section 13(a)(2), 15 U.S.C. § 80a-13(a)(2).

<sup>52</sup>Section 13(a)(3), 15 U.S.C. § 80a-13(a)(3).

<sup>53</sup>*Id.*

<sup>54</sup>Section 13(a)(4), 15 U.S.C. § 80a-13(a)(4).

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#### **4. Shareholder and Commission Actions under Section 36(b)<sup>55</sup>**

As a final measure of protection for investment company shareholders against fee-related conflicts of interest, section 36(b)<sup>56</sup> imposes, as a matter of federal law, a fiduciary duty on the investment adviser to a registered investment company with respect to the amount of compensation the adviser and its affiliates receive from the company and its shareholders.<sup>57</sup> The provision, enacted in 1970, is designed to provide an effective means for either the Commission or private shareholders to challenge excessive fees in a judicial forum. Both the Commission and any shareholder are authorized to bring an action for breach of this duty against the adviser, affiliated person of the adviser, or any other person listed in section 36(a) who has a fiduciary **duty** with respect to such compensation.<sup>58</sup>

### **111. The Debate over the Current Governance System and Recommendations for Reform**

There has been long-running and multifaceted debate over the efficacy of the system of investment company governance mandated by the Act. The debate has included such issues as whether the current system achieves the goal of effectively policing conflicts of interest; whether it costs too much for the results it achieves; whether the required structure has impeded the internationalization of the investment company industry and impeded the competitiveness of United States investment companies in the global market; and whether alternative regulatory structures could streamline governance requirements and fee structures without sacrificing investor protection. In this section, we discuss the most significant issues raised by both critics and proponents of the current investment

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<sup>55</sup>Section 36(b), 15 U.S.C. § 80a-35(b).

<sup>56</sup>Because section 36 is somewhat peripheral to governance issues, we only summarize its requirements here. Chapter 8 discusses section 36 more extensively.

<sup>57</sup>The fiduciary duty imposed by section 36(b) is unique in that it relates to the compensation received for performing fiduciary functions, and not the performance of those functions. The provision encompasses compensation for services or payments of a material nature paid by the investment company or its shareholders. This includes not only advisory fees, but any material fees the adviser or its affiliates receive for non-advisory services. Rule 12b-1 fees and service fees paid to affiliates of the adviser consequently are subject to section 36(b). Sales loads are excluded, however. Section 36(b)(4).

<sup>58</sup>Persons listed in section 36(a) include officers, directors, members of an advisory board, investment advisers, depositors, and principal underwriters. Such persons may be defendants in an action under section 36(b) only if they received compensation from the investment company. Damages are limited to actual damages and cannot exceed the amount of compensation received. Section 36(b)(3).

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company governance system and set forth our recommendations for reform, first with respect to the role of directors and then with respect to shareholder voting.

### A. The Debate over the Appropriate Role for Directors

Critics of the role assigned by the Act to investment company directors, and particularly the independent directors, believe that because an investment company is a creature of its sponsor/adviser, it is difficult for directors to provide effective oversight.<sup>59</sup> Because an investment company usually is managed by its sponsor or an affiliate, they argue, the independent directors are not truly independent, and have little choice but to approve the fee levels that the adviser deems necessary to operate the company and market its shares.<sup>60</sup> They cite court cases and Commission decisions where independent directors have not successfully challenged or even attempted to challenge certain management actions that allegedly violated the Act's self-dealing prohibitions.\* These critics also point out that independent directors almost never fire the adviser, and while they sometimes negotiate a fee rate below that proposed by the adviser, the amount of the reduction is usually marginal.<sup>62</sup>

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<sup>59</sup>Such criticisms are not new. For example, the WHARTON REPORT observed that:

[W]ith the selection of directors in the hands of a control group affiliated with the investment adviser, and where the board is typically outside the sphere of active management of the investment company, there is some question about the extent to which reliance can be placed on the independent directors to safeguard adequately the rights of shareholders in negotiations between the investment company and the investment adviser.

WHARTON REPORT, *supra* note 14, at 8.

<sup>60</sup>There is some contention that the increased responsibilities assigned to independent directors by Congress and the Commission may have caused those directors to become even more susceptible to control by the adviser. The theory is that as directors' salaries increase to reflect their increased responsibilities, their capacity for independence may diminish. This impairment may occur even if the directors are paid by the investment company, rather than (as was historically the case) by the adviser, particularly if the directors depend on compensation from the company. In such circumstances, the adviser's control of the proxy machinery, which in turn affects the directors' reelection, may hinder the ability of the independent directors to perform their duties with appropriate detachment. See Tamar Frankel, *Money Market Funds*, 14 REV. SEC. REG. 913,915 n.18 (May 20,1981).

<sup>61</sup>Victor Brudney, *The Independent Director -Heavenly City or Potemkin Village?*, 95 HARV. L. REV. 597 (1982).

<sup>62</sup>See, e.g., Werner Renberg, *Sixth Men or Fifth Wheels: Do Fund Directors Earn Their Paychecks?*, BARRON'S, Aug. 12, 1991, at M14.

(continued...)

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Supporters of the current role of investment company boards disagree. In their view, the conflicts presented by an externally managed entity make it uniquely appropriate that independent directors of investment companies take an active role in their governance. They assert that investment company shareholders need the protections provided by a third party monitor and that neither the Commission staff nor the market is capable of replacing the board in that role.<sup>63</sup> These observers generally approve of the long-term trend toward a stronger role for the independent directors, believing that many independent directors have developed a high level of expertise and have proved effective as monitors for shareholders. They point out that the investment companies have prospered under the current regulatory system, and have not experienced the abuses and mismanagement that recently have plagued other financial institutions. With respect to oversight of fees, they cite the success of defendants in section 36(b) fee litigation as evidence that the independent directors generally perform well in their review of advisory contracts and rule 12b-1 distribution plans.

Some industry observers agree that the independent directors are generally effective in their role as watchdogs for shareholders, but caution that improvements are needed to ensure their continued effectiveness. They believe that independent directors are unnecessarily burdened by requirements to make determinations that call for a high level of involvement in day-to-day activities requiring directors to "micro-manage" operational matters or to make detailed findings of fact. They also express concern about requirements that independent directors conduct reviews and make findings with respect to matters that have become routine or that involve virtually no discretion. In their view, these formalistic requirements unnecessarily clutter board meetings, making it difficult for directors to devote their time and attention to areas where they can exercise their business judgment most fruitfully.

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<sup>62</sup>(...continued)

In a recent section 36(b) lawsuit over the fees charged a fund, the trial judge noted that the independent directors had persuaded the adviser to accept a \$250,000 cut in \$56 million of fees and commented that they "had performed their responsibilities in a conscientious and careful manner." *Kalish v. Franklin Advisers, Inc.*, 742 F. Supp. 1222, 1249 (S.D.N.Y. 1990), *aff'd*, 928 F.2d 590 (2d Cir.), cert. *denied*, 112 S. Ct. 75 (1991).

<sup>63</sup>Proponents of the current system also point out that current governance arrangements require the adviser to go through an extensive and ongoing process of preparing information for directors to keep them informed. They argue that this process is beneficial because it compels the adviser to address and resolve issues that might otherwise not even be raised and increases the likelihood that operational problems will be identified at an early stage, when they can be most easily resolved. Perhaps more important, when mistakes or violations of law do occur, the independent directors are able to exert pressure on the adviser to act in the best interest of shareholders, whether that entails prompt and full disclosure of the problem, reimbursement of the investment company so that shareholders are "made whole," or other remedial action.

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## **B. Recommended Reforms of the Role of Directors**

After examining the current governance requirements of the Act as they relate to the role of directors, the various criticisms of those requirements, and proposals for reform, we have concluded that the corporate regulatory structure embodied in the Act is fundamentally sound. It nonetheless can be streamlined and improved by changes to both the structure and the responsibilities of investment company boards of directors.

Our recommendations concerning the role of directors are premised on two beliefs. First, we believe that the investment company governance system works best when the functions required of independent directors are performed by individuals who are truly independent. Measures that enhance the independence of independent directors, if they can be undertaken without undue expense, are consequently desirable.

Second, we believe that independent directors perform best when required to exercise their judgment in conflict of interest situations -- for example, when they review advisory contracts under sections 15(c) and 36(b) or review the use of affiliated brokers under rule 17e-1. We believe that independent directors are unnecessarily burdened, however, when required to make determinations that call for a high level of involvement in day-to-day activities. Rules that impose specific duties and responsibilities on the independent directors should not require them to "micro-manage" operational matters. To the extent possible, operational matters that do not present a conflict between the interests of advisers and the investment companies they advise should be handled primarily or exclusively by the investment adviser. Similarly, information gathering should be left to the adviser, the investment company's auditor, counsel, or outside consultants, as appropriate under the circumstances. Finally, in order to allow directors to devote their time and attention to truly important matters, we believe that provisions that require directors to conduct reviews and detailed make findings that involve more ritual than substance should be eliminated.

### **1. Structural Changes to Enhance Board Independence**

Section 10(a) provides that at least forty percent of the board of directors of a registered investment company must consist of independent directors. We recommend that this section be amended to require that more than fifty percent

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of the directors be independent<sup>64</sup> and, as is now required for funds that have rule 12b-1 plans, that they be self-nominating.

The primary reason for this recommendation is the trend in investment company regulation toward an increase in the oversight and policy responsibilities of independent investment company directors. Over the past two decades, the Commission, in a series of exemptive rules, has placed increasing reliance on boards of directors to monitor investment company operations. Our recommendation in Chapter 12 that rule 17d-1 be amended to allow investment company directors to approve certain types of joint transactions with remote affiliates would mark another step in this direction. We believe that an increased measure of independence is necessary<sup>65</sup> to allow independent directors to perform these responsibilities appropriately.<sup>66</sup>

Our recommendation to require that a majority of investment company directors be disinterested is also consistent with a trend in large industrial or

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<sup>64</sup>The original Senate bill that culminated in the Act would have required that a majority of investment company directors be independent. See S. 3580, 76th Cong., 3d Sess. § 10(a) (1940). That provision was changed in the House bill to a 40% requirement out of fear that a board with an independent majority would repudiate the recommendations of the adviser, depriving investment company shareholders of the benefits of those recommendations. Obviously, experience has proven this fear to be unfounded.

<sup>65</sup>Our concern is that in some situations disinterested directors may not be able to act with genuine independence in addressing conflict of interest situations because of direct or indirect influence by the adviser. The requirements that boards have a majority of independent directors and that independent directors be self-nominating are intended, in an environment where the role of independent directors has expanded significantly, to increase the likelihood that an investment company's directors would be able to act independently of management.

The requirement of an independent majority might make a voting difference, for example, in the statutory procedures for terminating an advisory contract. While the advisory contract and any annual continuances must be approved by the independent directors, it may be terminated only by the board as a whole or by a majority vote of shareholders. Section 15(a)(3). We also believe that having an independent majority may improve the dynamics of the decision-making process.

<sup>66</sup>Implementation of independence-enhancing measures might also benefit directors in litigation alleging breaches of fiduciary duty under section 36. In considering whether independent directors have carried out their responsibilities, courts have focused on the degree of independence of the directors, as well as whether their decisions were made in a reasonable and informed manner. See, e.g., Tannenbaum v. Zeller, 552 F.2d 402, 418-19 (2d Cir.), *cert. denied*, 434 U.S. 934 (1977) (decision by board of directors not deemed a violation of their fiduciary obligations where independent directors "(1) were not dominated or unduly influenced by the investment adviser; (2) were fully informed by the adviser and interested directors of [possible alternative courses of action]; and (3) [were] fully aware of this information, [and] reached a reasonable business decision . . . after a thorough review of all relevant factors").

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commercial companies, which do not have the unique structural conflicts faced by investment companies. Many of these companies (and their institutional shareholders) have recognized that having at least a majority of outside directors greatly improves the governance process, and consequently have found it appropriate to increase the number of outside directors on their boards.<sup>67</sup> It would be anomalous if investment companies had boards with proportionately fewer independent directors than most large industrial companies.

Finally, we believe that the change to require that a majority of investment company boards be composed of independent directors could be accomplished at a relatively small cost. Indeed, many, if not most, major investment company complexes already have boards with independent majorities!<sup>68</sup>

We also considered, but do not recommend, requiring investment companies to provide independent directors with their own staff or counsel.<sup>69</sup> While we recognize that a separate staff and counsel may be beneficial to independent directors and benefit investment company Shareholders, and that, in some circumstances, separate staff and/or counsel may be necessary for the board properly to perform its responsibilities under the Act, we also believe that independent directors are capable in many situations of making appropriate determinations without such assistance. We consequently conclude that the cost of requiring separate staff or counsel in all cases is not justified.

## **2. Addition of Authority for Independent Directors to Terminate Advisory Contracts**

Although independent directors are required to approve advisory contracts<sup>70</sup> and rule 12b-1 plans,<sup>71</sup> and have authority to terminate rule

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<sup>67</sup>According to an annual index of 100large corporations compiled by SpencerStuart Executive Search Consultants, the number of boards with a 4-to-1 or greater ratio of outside to inside directors has doubled to 40; and the number of inside directorships has fallen 30%. Only 5 of the 100 companies in the survey still have a majority of inside directors, down from 19 companies a decade ago. Timothy D. Schellhardt, *More Directors are Recruited From Outside*, WALL ST. J., Mar. 20, 1991, at B-1.

<sup>68</sup>See Lipper Director's Analytical Data Vol. 1, Sec. V, 321-424 (4th ed. 1991).

<sup>69</sup>See Letter from Francis X. Cain to Jonathan G. Katz, Secretary, SEC (Sept. 17, 1990), File No. S7-11-90.

<sup>70</sup>Section 15(c), 15 U.S.C. § 80a-15(c).

<sup>71</sup>Rule 12b-1(b)(2), 17 C.F.R. § 270.12b-1(b)(2).

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12b-1 plans,<sup>72</sup> they have no explicit autonomous authority to terminate advisory contracts. Only the full board or the shareholders can take such an action.<sup>73</sup>

Because we see no principled basis for this distinction, and because we believe that it is important for independent board members to have separate authority to protect shareholder interests by terminating an advisory contract, the Division recommends that section 15(a)(3) be amended to so provide.

### **3. Board Review and Approval of Service Contracts with Affiliates of the Adviser**

We also have considered the advisability of adding an explicit statutory requirement that independent board members review and approve, and have the power to terminate, service contracts with affiliates of the adviser. While we believe that scrutiny of service contracts with affiliates is an essential board function, we have concluded that it is not necessary to amend the Act to explicitly so require. In our view, the potential for section 36(b) liability by itself provides adequate incentive for board scrutiny in this area. While the parameters of what constitutes a breach of the fiduciary duty imposed by section 36(b) might be ambiguous in other contexts, we believe that liability with respect to service contracts with adviser affiliates may be established more easily. Proof that the investment company paid affiliates higher fees than outside contractors for the same services would go a long way toward establishing such liability, although comparing the quality of services provided may not always be straightforward.

### **4. Elimination of Formalistic Requirements under Existing Rules**

As discussed above, the Division recommends elimination of a number of rule provisions that make independent directors responsible for detailed findings of fact or for reviews and findings that involve more ritual than substance.

#### **a. Rule 12d3-1**

Rule 12d3-1<sup>74</sup> requires directors to determine that any debt security of an issuer that in its most recent fiscal year derived more than fifteen percent of its gross revenues from securities-related activity be "investment grade" to be eligible for investment by the company. We believe that determination of credit quality in this particular context does not present a conflict between the interests of the

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<sup>72</sup>Rule 12b-1(b)(3)(iii), 17 C.F.R. § 270.12b-1(b)(3)(iii).

<sup>73</sup>Section 15(a)(3), 15 U.S.C. § 80a-15(a)(3).

<sup>74</sup>17 C.F.R. § 270.12d3-1.

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investment company and its adviser, and thus is better left to a company's adviser.<sup>75</sup> The Division consequently recommends that the requirement for a board determination of credit quality be eliminated.

### **b. Rules 10f-3, 17a-7, and 17e-1**

Rules 10f-3, 17a-7, and 17e-1 require both the full board and the independent directors to oversee securities transactions with affiliates, to the extent that such transactions are permitted. Each of these rules allows affiliated transactions that otherwise would be prohibited under the Act to go forward, subject to the conditions or standards specified in the rule. Under each rule, the full board and a majority of the independent directors each must initially adopt procedures designed to assure that all relevant conditions and standards have been satisfied, review the procedures at least annually for "continuing appropriateness," and determine at least quarterly that all relevant transactions have complied with the established procedures.<sup>76</sup>

We believe that fixed annual review of operating procedures is unnecessary and recommend these rules be amended to delete this requirement. Each rule, however, should make clear that the full board and the independent directors continue to be concurrently responsible to review and update procedures whenever necessary. All other responsibilities imposed on the directors by these rules should be retained.

### **c. Rule 17f-5**

Rule 17f-5<sup>77</sup> requires directors annually to approve foreign custody arrangements after considering numerous legal matters, country risk factors, and factors relating to the particular foreign custodian. Because we believe that the selection and monitoring of foreign custodians does not present major conflicts between the investment company and the adviser, we recommend that rule 17f-5 be revised to limit the role of directors to one of general oversight of business decisions made by the adviser and the primary custodian.<sup>78</sup>

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<sup>75</sup>This rule does not allow for the purchase of a security issued by the adviser or one of its affiliates.

<sup>76</sup>Rules 10f-3(h), 17a-7(e), 17e-1(b), 17 C.F.R. §§ 270.10f-3(h), .17a-7(e), .17e-1(b).

<sup>77</sup>17 C.F.R. § 270.17f-5.

<sup>78</sup>Several commenters cited rule 17f-5 as a major source of frustration for directors. According to them, the rule is unduly burdensome and difficult to administer, and embroils directors in matters involving an inappropriate level of detail. They contend that independent directors have (continued..)

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We see two possible approaches that should be explored in rulemaking proceedings. One approach would be to revise the rule to make the adviser or the primary domestic custodian responsible for selecting and supervising foreign sub-custodians, under the general oversight of the board of directors. **Also**, or alternatively, the rule could be amended to require that the primary custodian provide appropriate indemnification protections for the investment company,

**d. Rule 17f-4**

Rule 17f-4<sup>79</sup> requires that directors initially approve and annually review arrangements involving the use of domestic securities depositories. We believe that annual review of such arrangements has become unnecessary. The use of domestic securities depositories has become an integral part of securities investing, and the dependability of depositories (for example, the Treasury/Federal Reserve Book Entry System and the Depository Trust Company) and of the depository concept in general has become well established. Thus, the Division recommends that rule 17f-4 be modified to require that directors approve securities depository arrangements initially, as well as any changes in such arrangements, while eliminating the annual review requirement.

**e. Rule 22c-1**

Finally, the Division recommends changes to rule 22c-1,<sup>80</sup> which now requires the directors to approve at least annually the time of day for determining net asset value. In our view, annual approval is unnecessary. We recommend that the rule be revised to require that directors initially approve the time of day for determining net asset value and approve any change proposed by the adviser. The rule should clarify that directors continue to be responsible for reviewing the pricing time whenever necessary and for changing it in response to new developments (e.g., evolution of twenty-four hour trading, or changes in the nature of the investment company's investments).

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<sup>78</sup>(...continued)

a limited factual basis to make the legal, operational, political, and economic judgments required of them by the rule, particularly when numerous foreign banks and clearing agencies may be involved. Moreover, they argue, it is inappropriate to expect directors to review the enormous volume of material that is developed annually to demonstrate compliance with the rule. According to some commenters, in practice directors rely almost exclusively on analysis and recommendations from the adviser, counsel, or the investment company's primary custodian.

<sup>79</sup>17 C.F.R. § 270.17f-4.

<sup>80</sup>17 C.F.R. § 270.22c-1.

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### C. The Debate over Investment Company Shareholder Voting

Critics of the Act's shareholder voting requirements view voting as a superfluous exercise. According to this view, investment company shareholders need not vote on changes in investment policies, given that they are motivated to "hire" the investment company's investment manager precisely because they wish to delegate their investment decisions to the manager. They need not vote on investment advisory and distribution fees because if such fees are too high, they can "vote with their dollars" and not buy the product. Similarly, if a moderate fee rate is subsequently raised, or if investors otherwise become unhappy with an adviser's performance, they can "vote with their feet" and redeem.<sup>81</sup>

In addition, voting rights critics contend, and offer strong proof, that investment company shareholders are essentially passive.<sup>82</sup> In their view, the

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<sup>81</sup>Many critics of the Act's shareholder voting requirements -- including those who advocate implementation of the UIF -- contend that such requirements misconstrue the fundamental nature of the relationship between the sponsor and investors, which they believe is contractual. They argue that in such a relationship, investors should not be treated as owners. The argument that shareholder voting requirements should be eliminated, however, is not endorsed exclusively by those who would do so only in the context of the UIF or similar alternatives; some critics of voting rights have argued for the elimination of voting rights for all investment companies. See Richard M. Phillips, *Deregulation under the Investment Company Act - A Reevaluation of the Corporate Paraphernalia of Shareholder Voting and Boards of Directors*, 37 BUS. LAW. 903, 908-910 (1982). Indeed, in 1982, when the Commission first requested public comment on the UIF concept, it also requested comment on the advisability of modifying the Act to enable all or certain types of open-end investment companies to be organized and operated without shareholder voting. Advance Notice and Request for Comment on Mutual Fund Governance, Investment Company Act Release No. 12888 (Dec. 10, 1982), 47 FR 56509. While the UIF proposal received a lukewarm response from commenters, the proposal to eliminate shareholder voting received considerable support. The Commission did not take further action.

<sup>82</sup>For example, critics point to the findings of the WHARTON REPORT, *supra* note 14, and the Commission's endorsement of those findings in the PPI REPORT, *supra* note 14. The WHARTON REPORT concluded that the Act's shareholder voting provisions appeared to be of "limited value" in governing the relationships between funds and their investment advisers and principal underwriters, and that "the very concept of shareholder control through the exercise of voting rights may be contrary to the realities of the mutual fund business." WHARTON REPORT at 7-8. The report attributed ineffectiveness of shareholder voting to "the wide diffusion of ownership . . . [coupled with] the redemption feature of mutual fund shares which facilitates exit from the fund as the normal outlet for dissatisfaction with management performance." *Id.* at 64.

It is difficult to dispute the contention that investment company shareholders are passive. While in theory proxy voting should be an important mechanism through which shareholders express opinions and attempt to influence management, short of the more final step of redemption, in practice, investment company shareholders do not appear to use their vote to great  
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typical investment company shareholder has neither the desire nor the ability to be an active owner and to digest the large amount of material that must necessarily be considered in order to make decisions on fee levels and investment policies.

Advocates of voting rights for investment company shareholders argue that such rights are beneficial even assuming shareholders are passive. They contend voting is a fundamental characteristic of share ownership and provides a needed restraint on investment company management. While acknowledging both that investment company shareholders rarely disapprove management proposals, even those that would raise fees, and that proxy contests are practically non-existent for open-end companies,<sup>83</sup> they nevertheless maintain that voting rights play a useful role in opening channels of communication between investors and management and deterring management abuse. They also point out that shareholder voting gives the board additional leverage in negotiating with the adviser concerning matters that are of importance to shareholders. Finally, they point out that there are still disincentives to redemption -- including front end and deferred sales loads, redemption fees, and adverse tax consequences -- which may impose a significant cost penalty and may deter shareholders from redeeming. In their view, such disincentives make shareholder voting far from superfluous.

Some voting rights proponents also argue that the costs of the shareholder voting process are de minimis. These commenters contend that the industry has responded rapidly to moves by certain states to adopt more liberal corporation laws and, as a result, the vast majority of investment companies are now domiciled in states that do not require them to hold an annual shareholders' meeting. They assert that most shareholders' meetings consequently are held to consider important matters such as an increase in the advisory fee rate, imposition

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<sup>82</sup>(...continued)

effect. Many industry participants and observers have told the staff that investment companies often find it difficult to obtain a quorum, meeting attendance is usually sparse, and a vote outcome is almost never contrary to the wishes of management.

<sup>83</sup>Occasionally, however, investment company shareholders do vote against the recommendation of management. Recently, T. Rowe Price ("Price") recommended that six companies in its complex which invest abroad or in small company issues adopt a one percent redemption fee. Under the proposal contained in fund proxy statements, shareholders who redeem shares shortly after they are purchased (within either 6 or 12 months) would be assessed a fee in order to compensate the funds for extra transaction costs created by short-term trading. Fee proceeds would be kept by the fund. According to newspaper accounts, the proposals prompted an outpouring of letters to Price. When the votes were counted, shareholders approved the fees for four funds and rejected them for two others. Price decided not to ask the board of directors of any of the funds to implement the fees. Carole Gould, *Mixed Reviews on Redemption Fees*, N.Y. **TIMES**, May 12, 1991, sec. 3, at 14.

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of a rule 12b-1 plan or an increase in its fee rate, or revision of a fundamental investment policy; and that relatively few meetings are held solely to vote on routine matters such as election of directors or ratification of auditors.<sup>84</sup>

## **D. Recommended Reforms of Investment Company Shareholder Voting**

Our analysis and recommendations concerning the appropriate role of shareholder voting in the regulation of investment companies are premised on a simple, but not easily applied, test. Do the benefits of statutorily required shareholder voting, both in the global sense and with respect to particular sections of the Act, outweigh its costs? Based on this analysis, we propose to eliminate several obsolete shareholder voting requirements, modify others to comport with the realities of modern day securities markets, and add an express voting requirement for changes in investment objective.

### **1. The Costs and Benefits of Investment Company Shareholder voting**

There obviously are costs associated with the shareholder voting requirements imposed by the Act. These costs include the costs of proxy solicitation (such as legal and accounting fees incurred in connection with preparing proxy material and printing and mailing costs incurred in the distribution of such material), the cost of resolicitation if necessary in order to achieve a quorum, and the costs of holding annual or special meetings of shareholders.

It is difficult to estimate the magnitude of these costs with any degree of accuracy, or even to extrapolate how those costs have changed over time.<sup>85</sup>

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<sup>84</sup>For example, the IDS Mutual Fund Group did not hold a regular meeting of shareholders for any of its funds over a three year period between **1988** and **1991**. Letter from **IDS** Mutual Fund Group to Jonathan G. Katz, Secretary, SEC (Sept. 26, 1990), File No. **S7-11-90** [hereinafter **IDS** Study Comment]; and telephone conference with Leslie Ogg, **IDS** General Counsel, updating information set forth in **IDS** Study Comment.

<sup>85</sup>In comments responding to the Study Release, Lipper Analytical Services, Inc. provided the most detailed analysis of the costs of investment company governance, using data from 2,524 investment companies for which current fiscal year data are available. Letter from Lipper Analytical Services, Inc. to Jonathan G. Katz, Secretary, SEC (Oct. 9, 1990), File No. **S7-11-90** [hereinafter Lipper Study Comment]. These data, however, related primarily to the costs associated with independent directors. See *infra* notes **116-118** and accompanying text. With respect to shareholder voting, Lipper stated that "[w]e do not have a way to identify the costs of proxy solicitation, but we can say with certainty that these costs have been reduced materially in recent years." Observing that changes in state law have enabled investment companies to reduce greatly the frequency of shareholder meetings, Lipper maintained that "the proxy solicitation of (continued...)

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Generally, however, the cost of shareholder voting undoubtedly has decreased significantly on a per-fund basis as a result of a 1986 Division interpretive position that the Act does not require annual meetings to elect directors<sup>86</sup> and related changes in state law following that pronouncement. Most significantly, at least five states (Delaware, Maryland, Minnesota, California, and Massachusetts) have business trust or special corporate law structures that have the effect of not requiring shareholder meetings other than those required by the Act.<sup>87</sup> As of March 1991, over eighty-four percent of open-end investment companies were organized as Maryland corporations or Massachusetts business trusts.<sup>88</sup> Thus, to a large extent, the costs of shareholder voting have been minimized by changes in state law.<sup>89</sup>

Finally, we note that potential cost savings resulting from the elimination of shareholder voting would be significantly diminished by the continuing need to provide notice to shareholders of changes that are currently described in the proxy statement. In fact, it appears that proxy statement preparation, printing and mailing costs represent the bulk of the costs of shareholder voting. Because most shareholder voting requirements arise from significant changes in investment company operations, and because the Commission would undoubtedly require that shareholders be notified of such significant changes even if voting were eliminated, we do not believe that cost savings associated with eliminating shareholder voting would be appreciable.

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<sup>85</sup>(...continued)

old which did no more than ask for a vote on directors and an approval of auditors is becoming an anachronism."

<sup>86</sup>John Nuveen & Co. Inc. (pub. avail. Nov. 18, 1986). This no-action letter pointed out that section 16(a) expressly requires a meeting to elect directors only (1) for the initial board and (2) to fill vacancies if less than a majority of the board is elected by shareholders. The letter took the position that the necessity for annual meetings was generally a question of state law.

<sup>87</sup>DEL. CODE ANN. tit. 12, § 3806 (Supp. 1990); MD. CORPS. & ASS'NS CODE ANN. § 2-501(b) (Supp. 1991); MINN. STAT. § 302A.431 (1991); CAL. CORP. CODE § 600(b) (West 1990); MASS. ANN. LAWS. Ch. 182 (Law. Co-op 1987).

<sup>88</sup>Lipper Analytical Services, The "Form" Used by Mutual Funds to Organize State by State (Mar. 1991)(survey prepared for the Investment Company Institute).

"Costs associated with shareholder voting requirements have also been lowered by the Commission's revision of proxy rule 14a-6(a), 17C.F.R. § 240.14a-6(a), to eliminate the requirement that investment companies file preliminary proxy material with the Commission with respect to meetings at which only routine proposals will be considered. Proxy Rules; Amendments to Eliminate Filing Requirements for Certain Preliminary Proxy Material; Amendments With Regard to Rule 14a-8, Shareholder Proposals, Securities Exchange Act Release No. 25217 (Dec. 21, 1987), 52 FR 48977.

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Our views on the benefits of investment company shareholder voting straddle the middle ground between those who advocate voting rights and those who propose their elimination.” On the one hand, we believe that, at the very least, voting rights serve an important communicative and deterrent function, particularly in circumstances where there are impediments to redemption. Accordingly, we do not favor large-scale elimination of voting rights on issues that may have a major effect on investment company operations. We also agree, however, with those who advocate the elimination of shareholder voting rights that under the current structure voting is often a “ritualistic anachronism.”<sup>91</sup> This is particularly true when the required voting relates to matters that have little relationship to investor protection concerns.

## 2. Conclusions and Recommendations on Shareholder Voting

Against this background, we have developed the recommendations described below. These recommendations are premised on the underlying belief that investors should continue to have the opportunity to vote on proposals that significantly alter the nature of the investment, and, in effect, require another investment decision on their part. We are also guided by the principle that voting requirements imposed by the Act should relate to matters that are of particular concern to investment company shareholders from an investor protection perspective, and should reflect the realities of modern securities markets. We consequently recommend that voting requirements that have become outdated and have no current bearing on investor protection concerns be eliminated or modified.<sup>92</sup> Finally, in circumstances where there are no significant obstacles to redemption, we believe that shareholder voting requirements should be streamlined to the greatest extent possible.<sup>93</sup>

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<sup>90</sup>We do not believe that the argument between advocates of voting rights and those who propose their elimination can be, or need be, finally settled. In our opinion, proponents of each position plausibly describe some, but not all, aspects of the operation of investment companies, and offer compelling arguments in support of their views.

<sup>91</sup>Phillips, *supa* note 81, at 910.

<sup>92</sup>In each instance where we recommend that an existing voting right be eliminated, we expect to develop rules to require that shareholders receive equivalent information to that which they now receive in proxy statements. We believe that disclosure should be made at least after the fact with respect to all matters for which a vote is currently required. For certain matters, however, advance notice may be appropriate.

<sup>93</sup>This premise is one of the bases for our recommendation concerning shareholder voting requirements in the context of the unified fee investment company (“UFIC”). See Chapter 8. While we believe that voting requirements should be streamlined for the UFIC, we are simply not convinced that it makes sense to eliminate all voting rights for that or any other type of  
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## **a. Voting Requirements That Should Be Eliminated**

### **i. Ratification of Investment Company Auditors**

The Division recommends repeal of the section 32(a) requirement that shareholders ratify the selection of investment company auditors if a shareholders' meeting is held. While this is not a particularly costly requirement, in that it is imposed only in situations where a shareholders' meeting is already being held, we believe that review of the adviser's selection of the auditors is a task appropriately left to the board of directors in all cases, unless they seek shareholder ratification.

### **ii. Initial Approval of Advisory Contracts and Rule 12b-1 Plans**

The Division recommends that section 15(a) be revised to eliminate the need for a vote on the investment advisory contract by the initial shareholders. Currently, after the board of directors has approved the advisory contract, a management investment company that is still in its organizational stage holds a shareholders' meeting so that those persons that have supplied the \$100,000 seed capital required by section 14(a)<sup>94</sup> can vote on the contract. In almost all cases this entails a meeting at which the sponsor, as initial shareholder, votes to approve an advisory contract it has negotiated with itself, or with its advisory affiliate. The purpose of such a "vote" is nonexistent and the outcome of such a "vote" is automatic. Occasionally, however, the initial capital is supplied by persons other than the sponsor. We believe that because these persons have voted with their dollars to accept investment advisory arrangements that have

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<sup>93</sup>(...continued)

investment company. In our view, voting rights do serve a communicative and deterrent function. A decision to eliminate such rights might be justified only if it were demonstrated that significant cost savings would be achieved and that shareholders, having been informed of significant management decisions before they occur, would have an unrestricted ability to redeem and invest elsewhere if they object to those decisions, (*i.e.*, there are no disincentives to redemption). There has been no showing that the elimination of shareholder voting would result in significant cost savings. Indeed, given the changes in state law over the last decade, we think it unlikely that any such a demonstration could be made. In addition, while we acknowledge that for certain **types** of funds redemption is a cost free alternative to voting for many investors, we also believe that -- even for no-load funds -- there are disincentives to redemption (including tax consequences) for some investors.

<sup>94</sup>15 U.S.C. § 80a-14(a).

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been disclosed to them, a separate vote on the advisory contract is largely redundant.<sup>95</sup>

The Division also recommends revising its interpretation requiring new mutual funds or new series of existing funds to hold a shareholders' meeting during the first sixteen months of operations to allow the public shareholders to vote on the investment advisory contract and vote on any rule 12b-1 plan?<sup>6</sup> We agree with those who argue that this shareholder vote is unnecessary because investors in a newly organized fund or series have already voted with their dollars to accept these arrangements. We believe that a separate proxy vote is not necessary until management proposes that these arrangements be changed.<sup>97</sup>

### **b. Voting Requirements That Should Be Retained or Added**

As previously noted, we believe that shareholders of current investment companies should have the opportunity to vote on proposals that significantly alter the nature of their investment and proposals that are of particular concern from an investor protection perspective. Applying this standard, we first, and most importantly, recommend that sections 8(b) and 13(a) of the Act be amended to classify as fundamental a company's investment objective. An investment company's investment objective is one of its most defining attributes. A change in objective, for example, from income to capital appreciation (or *vice versa*) dramatically alters the nature of the shareholders' investment, requiring in effect, a new investment decision. We believe that a change of this magnitude should be permitted only if it is authorized by shareholder vote.

In addition, we recommend that there be no change in: (a) the current section 16(a) requirement that at least two-thirds of the membership of the board

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<sup>95</sup>Requiring shareholder approval of an advisory contract when a sponsor adds ~~an~~ additional series to an existing investment company is an equally meaningless ritual. In such situations, there is no initial capital requirement, ~~and~~ the new series usually issues a special "share" to the sponsor to enable it to approve the advisory contract for that series.

<sup>96</sup>See Letter from Carolyn B. Lewis, Assistant Director, Division of Investment Management, SEC, to Registrants at 2 (Jan. 3, 1991).

<sup>97</sup>In addition to the voting requirements discussed above, the Division also recommends that shareholders no longer be required to vote on a change in an open-end company's fundamental investment policy regarding investments in real estate and underwriting securities issued by other persons, as is currently required by sections 8(b)(1) and 13(a)(2). The reason, however, is not that we view these rights as unimportant. Indeed, changes in these policies may significantly affect a fund's liquidity and level of risk. Rather, we are recommending elimination of this requirement because in Chapter 11, we recommend the addition of an explicit statutory liquidity requirement, which would obviate the need for a shareholder vote on these issues. If this liquidity requirement is not implemented, the voting requirements should be retained.

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of directors consist of directors who have been elected by shareholders;<sup>98</sup> (b) the requirement that increases in investment advisory fees and rule 12b-1 fees be subject to shareholder approval;<sup>99</sup> (c) the requirement that shareholders vote on assignments of advisory contracts and on new advisory contracts following termination of an advisory contract by the board; (d) the current section 13(a)(4) requirement for shareholder approval of a change in the nature of business "so as to cease to be an investment company"; (e) the section 13(a)(1) requirement of shareholder approval for a change in an investment company's subclassification from "issuer-diversified" to "issuer non-diversified,"<sup>100</sup> or a change in either direction from open-end to closed-end company; and (f) the section 13(a)(2) requirement of shareholder approval of changes in an investment company's fundamental investment policies for borrowing and issuing senior securities.<sup>101</sup>

### **c. Voting Requirements That Should Be Modified**

The Division believes that several fundamental investment policy requirements imposed by sections 8(b) and 13(a) should be revised to comport more closely with the realities of today's financial markets.

#### **i. Lending**

Sections 8(b) and 13(a)(2) require that a registered investment company recite in its registration statement its policy with respect to "mak[ing] loans to other persons." This recitation of policy currently must encompass the company's use of repurchase agreements,<sup>102</sup> the lending of portfolio securities, and the purchase of privately-offered debt securities (collectively "security-based loans").

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<sup>98</sup>This requirement enhances the legitimacy of directors as shareholder representatives, and, because shareholder meetings are rarely commenced solely for the purpose of electing a director, is practically cost-free.

<sup>99</sup>As discussed previously, however, we recommend eliminating these voting requirements for newly organized companies.

<sup>100</sup>These terms would be substituted for the terms "diversified" and "non-diversified" that are now contained in sections 5(b)(1), 5(b)(2), and 13(a)(1).

"Section 18 limits the extent and the means by which investment companies may borrow or issue senior securities for the purpose of employing investment leverage. Within the limits set by section 18, these fundamental policies control the degree of investment leverage an investment company may undertake. A change in either policy may significantly change the risk-reward characteristics of the shareholders' investment.

<sup>102</sup>See section 2(a)(23), 15 U.S.C. § 80a-2(a)(23) ("lend" includes a purchase coupled with an agreement by the vendor to repurchase; 'borrow' includes a sale coupled with a similar agreement").

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The Division recommends that sections 8(b) and 13(a) be amended to narrow the scope of transactions included under this fundamental policy -- in particular by excluding "security-based loans."

In our view, the inclusion of security-based loans in a policy designed to regulate loans to other persons ignores the realities of modern securities markets. In such markets, repurchase agreements are a standard short-term cash management technique; securities are commonly loaned on a short-term basis to earn extra income on portfolio assets; and institutional investors such as investment companies routinely purchase debt instruments that are not publicly offered. These transactions generally have no more than a modest effect on an investment company's overall risk or return. Consequently, while we believe that security-based loans should continue to be subject to substantive regulation to ensure that they are conducted in a prudent and responsible manner, we also believe that a continued requirement for shareholder approval of any change with respect to these activities serves no useful purpose.

## **ii. Concentration**

The Division recommends several changes to the shareholder voting requirements for investment "concentration" in a particular industry or group of industries. As explained below, the net effect of our recommendations would be to treat "concentration" in the same way that the Act currently treats investment diversification among issuers, *i.e.* to require a shareholder vote only when an investment company moves from being diversified to being non-diversified, but not the reverse.

Under current law, a shareholder vote is required for an investment company to move into or out of "concentration" in a particular industry or group of industries. The Division currently interprets "concentration" as an investment of twenty-five percent or more of company assets in a single industry or group of industries. An investment company may not reserve freedom of action to move into and out of concentration in an industry. Thus, a company that specifies in its registration statement an intention to concentrate must invest at least twenty-five percent of its assets in the identified industry, unless it adopts a temporary defensive position in anticipation of a market decline. If the registration statement specifies no intention to concentrate, the company may not invest more than twenty-five percent of its assets in one industry.

We believe that the current treatment of "concentration" as a fundamental investment policy is flawed in two major respects. First, it may prevent an investment company's adviser from reallocating portfolio assets among industries in a way that best reflects its analysis of current market conditions, even if such action would pose little or no risk to shareholders. In particular, we think that

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the current policy is flawed in requiring shareholder approval before the adviser can move the company from a more risky non-diversified position to a relatively less risky diversified position. Second, there is an issue of terminology or, perhaps, semantics. We are unaware of the term "concentration" being used anywhere outside the Act to describe the extent to which an investment portfolio is divided among issuers from different industries. Instead, portfolio managers and investors commonly refer to this portfolio attribute as "industry diversification."<sup>103</sup>

To cure these defects, the Division first recommends that section 8(b)(1) be amended to remove "concentrating investments in a particular industry or group of industries" from the list of fundamental investment policies and that section 13(a)(3) be amended correspondingly.<sup>104</sup> The effect of this change would be to eliminate the requirement that shareholders approve a change in either direction in a company's "concentration" policy. Second, because we believe that the extent to which an investment portfolio spreads its investments among different industries is an important determinant of its level of risk, and that investors should be able to determine whether or not an investment company portfolio must be industry diversified, we recommend that (irrespective of difficulties in defining an industry) investment companies be required to label themselves with respect to portfolio diversification among industries in the same manner that they must currently label themselves with respect to portfolio diversification among issuers, *i.e.*, as "industry diversified" or "industry non-diversified" investment companies.<sup>105</sup> Finally, the Division recommends that

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<sup>103</sup>In addition to the defects described above, the current treatment of "concentration" suffers from problems of industry definition. There is no clear standard to determine what constitutes an "industry," much less "a group of industries." Indeed, as the boundaries between different industries erode and the trend toward corporate diversification and conglomeration continues, it is often difficult to fit companies into distinct industry categories (*e.g.*, in which industry is General Electric?). Moreover, in many cases, an imaginative counsel can structure a concentration policy to provide the adviser with considerable freedom of action by defining particular industry groupings broadly or narrowly, as desired. We recognize that our recommendation does nothing to cure these problems. Under our proposal, however, industry definition would become less important because the adviser would have greater discretion to move from non-diversified to diversified status.

<sup>104</sup>See Guide 19 to Form N-1A, Registration Form Used by Open-End Management Investment Companies, Investment Company Act Release No. **13436** (Aug. 12, 1983), **48 FR 37928,37962**.

<sup>105</sup>Currently, sections 5(b)(1) and (2) require an investment company to identify itself as "diversified" or "non-diversified" based upon whether it must invest in at least a minimum number of issuers. 15 U.S.C. §§ 80a-5(b)(1), -5(b)(2). We recommend adding new subsections (3) and (4) to section 5(b) that would, in a similar manner, require investment companies to label themselves as "industry diversified" or "industry non-diversified" investment companies. To avoid confusion, we also recommend revising the terminology used in sections 5(b)(1), 5(b)(2), and  
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section 13(a)(1) be amended to require shareholder approval for an investment company to change its classification from "industry diversified" to "industry non-diversified" status. This change would ensure that shareholders are given the opportunity to vote on a change in the composition of the investment company's assets that may significantly increase their level of risk.<sup>106</sup>

## IV. Alternative Governance Arrangements

Disenchantment with the present investment company governance structure has led some to endorse radically simplified governance arrangements such as the unitary investment fund ("UIF").<sup>107</sup> Originally proposed in 1980,<sup>108</sup> the UIF is an alternative form of open-end management investment company whose structure is predicated on the belief that an investment company is a proprietary product, more suited to a contractual arrangement than to corporate democracy. Its advocates claim that the UIF's simplified governance and fee arrangements would be more flexible for the manager and more comprehensible to investors.

To determine whether the UIF is a desirable or acceptable alternative to the traditional governance structure currently required by the Act, we examined a number of aspects of the UIF proposal and how they would affect the regulation

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<sup>105</sup>(...continued)

13(a)(2) to refer to "issuer diversified" and "issuernon-diversified" investment companies. See *supra* note 100 and accompanying text.

The 25% asset composition test that currently defines the "concentration" border under Guide 19 to Form N-1A would continue to be used as the dividing line between "industry diversified" and "industry non-diversified" investment companies.

<sup>106</sup>Under our recommendation, the adviser of a company that elects industry non-diversified status thus would be free to move the company into and out of industry non-diversified status at any time while the adviser of a company that elects industry diversified status would be required at all times to invest less than 25% of portfolio assets in any single industry. Of course, the prospectus of an industry non-diversified investment company would have to identify the company's non-diversified status and describe the risk factors that accompany this status.

<sup>107</sup>The Commission first requested public comment on the UIF in 1982. Inv. Co. Act Rel. 12888, *supra* note 81. Most commenters opposed the UIF, based largely on concerns about the adequacy of investor protections for UIF investors and unresolved questions about how the concept would work in practice. In the Study Release, the Commission asked commenters to assess the TUIF in light of the numerous changes that have occurred in the investment company industry since 1982, including, most notably, the increasingly global nature of securities markets, and the increased complexity of fee structures and methods of paying for distribution.

<sup>108</sup>Stephen K. West, Address at the General Meeting of the Investment Company Institute (May 1, 1980).

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of investment companies. In particular, we analyzed whether the single fee structure would eliminate the need for the layers of fee review that exist today, whether the traditional governance structure is needed for other investor protection purposes, whether the UIF would result in any significant cost savings, and what impact the UIF would have on internationalization.

We conclude that, although the UIF's approach to fees generally is sound and should be implemented with minor modifications,<sup>109</sup> there is no practical substitute for the oversight of boards of directors regarding investment company operations. Moreover, the cost savings of the UIF appear to be minimal, and we do not believe the UIF would facilitate internationalization significantly.

### **A. The Original Unitary Investment Fund Proposal**

As proposed in 1980, the UIF would have the following key features:

- (1) The UIF would be an optional form of investment company, similar in form to a trust, with a corporate trustee (the sponsor/manager), a trust indenture (which would spell out fundamental investment policies and the management fee), and investors holding interests in the trust.
- (2) A single management fee would cover all expenses, except for extraordinary expenses and shareholder account services. The fee would be subject to a statutory maximum, which the Commission could increase by rulemaking. No limit would be placed on the percentage of the fee that could be used for distribution expenses.
- (3) The UIF would have no board of directors or shareholder voting, nor would section 36(b) apply.
- (4) During an initial period (perhaps five years) the indenture could not be amended without an exemptive order from the Commission. Thereafter, the sponsor could amend the indenture at any time upon adequate notice to investors. Shareholders objecting to a change could redeem.
- (5) The UIF would either be no-load or would refund the sales charge upon redemption in most situations.
- (6) All section 17 prohibitions concerning transactions with affiliates would apply. Because there would be no board of directors to

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<sup>109</sup>See Chapter 8.

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prevent the sponsor's brokerage affiliate from charging excessive commissions to a UIF, agency transactions with affiliates currently allowed under section 17(e) would be prohibited.

- (7) The UIF could not engage in activities that rely on rules or exemptive orders conditioned on director oversight unless mechanical rules or individual exemptive orders were substituted for such oversight.<sup>111</sup>

## B. Investor Protection Issues

Assuming that the single fee approach would be an adequate substitute for the current system of director, shareholder, and judicial review of fees, the question remains whether the corporate model is necessary for other investor protection purposes. We conclude that it is. In short, investment company shareholders should have certain protections provided by an independent third party monitor and, to a lesser degree, by shareholder voting.

As previously discussed, under the Act and the rules thereunder, directors oversee investment company operations in many areas that do not involve fees.<sup>112</sup> While rejecting the notion that a board of directors is essential, UIF proponents offer no practical alternative for the board's oversight in these areas,<sup>112</sup> nor are we able to advance one.

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<sup>111</sup>Since the time of the original proposal, a number of variations have been suggested. For example, some advocates of the UIF now take the position that even UIF shareholders should have voting rights. These commenters believe that a UIF sponsor should be able to recover distribution costs through front-end and contingent-deferred sales charges as well as through the asset-based fee paid by the UIF. Since a UIF would have no board of directors to review proposed fee increases and investment policy changes on behalf of shareholders, these commenters would require the sponsor to obtain shareholder approval of any such changes. Others, citing investor protection concerns, have recommended that any UIF structure retain independent directors to exercise oversight over the affairs of the company. Finally, although the original proposal included a statutory maximum fee that the Commission could increase through rulemaking, no pro-UIF commenters would retain this provision. Some UIF proponents, however, would continue to require that fee increases be subject to shareholder approval.

<sup>112</sup>See *supra* notes 25-36 and accompanying text (describing board responsibilities).

<sup>112</sup>For example, some commenters suggested that, in most cases, matters currently reviewed by independent directors could be detailed in the trust indenture (e.g., a money market fund's indenture could spell out the criteria that must be followed by the investment manager in order to comply with rule 2a-7 in the absence of board review), but no commenter provided any analysis of how the various rules that look to directors could be modified to operate without directors. See, e.g., Letter from the Investment Company Institute to Jonathan G. Katz, Secretary, SEC at 31 (Oct. 5, 1990), File No. S7-11-90.

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The most obvious means of replacing the independent directors would be to substitute the trustee or custodian, in much the same way that a "depositary" is used in the European Council Directive of 20th December, 1985 on the Coordination of Laws, Regulations and Administrative Provisions Relating to Undertakings for Collective Investment in Transferable Securities (the "UCITS Directive").<sup>113</sup> Under the UCITS Directive, a fund's depositary is supposed to act in a general oversight capacity for all fund operations. Such a change would not appear to create significant cost savings, however, since presumably a depositary would insist on some level of compensation, and as discussed below, the costs of the present structure are minimal. In the absence of demonstrable savings, we see no reason to substitute depositaries for independent directors, given the generally successful functioning of investment company boards.

Another alternative, mentioned in the original UIF proposal, would be to substitute greater oversight and examination by the Commission. We believe, however, that this suggestion is unrealistic given fiscal constraints, and also is unlikely to result in any net cost savings.

We are also concerned that the UIF would create unchecked incentives for advisers to cut corners on basic services to meet competitive pressures -- for example, by hiring the proverbial "shoebox" custodian. Even in the absence of competitive pressures, an unscrupulous adviser might be tempted to cut back or eliminate basic services to bolster its own profitability. This obviously is of great concern from an investor protection perspective. Without a third party monitor to oversee the level of services, investors would be virtually left to their own devices, but typically without the expertise, incentive or power to assess the quality of these services.

Finally, we believe that, even in the context of a single fee arrangement, shareholder voting plays an important investor protection role in connection with a limited range of investment company operational activities such as investment company mergers, a change from closed-end to open-end, or a change in an investment company's investment objective. We consequently disagree with the contention that shareholder voting should be eliminated entirely in a UIF context.<sup>114</sup>

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<sup>113</sup>Council Directive 85/611, 1985 O.J. (L375) 3.

<sup>114</sup>For this reason, we recommend in Chapter 8 that certain shareholder voting rights be retained for the UFIC.

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### C. Cost Considerations

Proponents of the UIF argue that significant cost savings would result from its implementation as a consequence of a reduction in governance. After examining the issue and reviewing various estimates of cost savings submitted by commenters, however, we conclude that elimination of the corporate structure as adapted to investment companies would result in only minimal cost savings. As we have previously discussed, many of the cost savings that the UIF was designed to achieve have already been realized by changes in state laws since the UIF was first proposed.<sup>115</sup> In our view, the principal savings from implementation of the UIF would result not from the elimination of the corporate structure *per se*, but from the elimination of the multilayered review and approval of various fees now required by the Act.

Lipper Analytical Services, Inc. provided the most detailed analysis of the costs of investment company governance.<sup>116</sup> Lipper concluded that, based on available data, the potential cost savings from eliminating the governance structure are *de minimis*. According to Lipper, the industry-wide dollar weighted average cost to shareholders of independent directors is 0.005%, or one-half of one basis point. In dollar amounts, the median director expense for an individual fund is \$8,261; the mean expense \$14,646; and the dollar weighted average \$50,484. In percentage terms, the median director expense is 1 basis point, the mean 3.5 basis points, and the dollar weighted average 0.5 basis points.<sup>117</sup> With respect to the legal expense of the independent director system, the median expense incurred for "professional fees" -- which often includes audit expenses in addition to legal fees paid by the fund -- is \$30,000, according to Lipper. Dollar weighted "professional fee" expense as a percentage of net assets is 0.014%, or slightly less than 1.5 basis points.

Thus, allowing for overstatement of legal expenses resulting from use of the "professionalfee" data, Lipper estimates that total governance costs, including

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<sup>115</sup>See *supra* notes 85-89 and accompanying text.

<sup>116</sup>See Lipper Study Comment, *supra* note 85, at 1. Lipper identified the costs of current governance arrangements as including the fees and expenses of independent directors, the cost of proxy solicitation, the costs of counsel for the independent directors, and the costs incurred in preparing materials and reports for directors. As previously discussed, Lipper was unable to quantify the costs of proxy solicitation, but believed that such costs have been reduced materially in recent years as a result of changes in state laws. It did provide cost savings estimates with respect to all other cost components.

<sup>117</sup>Cost calculations performed on the basis of median or average (mean) costs give more weight to the costs incurred by small companies than do calculations of dollar weighted average cost. Dollar weighted average cost, by giving more weight to large companies, better reflects the costs that most shareholders actually pay.

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the occasional mailing of proxy material, do not exceed two basis points for the typical investor. Compared with an average total expense ratio of 1.118% (approximately 112basis points) for **2,731** funds (and median and dollar weighted average expense ratios of 0.950% and 0.767%, respectively), such costs are insignificant.<sup>118</sup>

#### D. The Impact of the UIF on Internationalization

We also considered whether the UIF would facilitate efforts to provide a common legal framework for cross-border sales of investment company shares. We conclude that it would not significantly facilitate those efforts.

In some ways, the UIF resembles the structure predominantly used in Europe, commonly known as the UCITS.<sup>119</sup> Such similarity, however, does not necessarily lead to the conclusion that the governance structure established by the Act should be vitiated in an effort to promote internationalization. As one commenter noted,<sup>120</sup> models of investment company regulation outside the United States "were developed under different conditions and in different environments. Accordingly, they may not be suitable for the domestic United States investment company industry."<sup>121</sup>

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<sup>118</sup>Two other commenters provided estimates of the costs of governance under current law. IDS Mutual Fund Group, put the costs of directors as a percentage of fund net assets at under three-tenths of a basis point (0.0028%) and estimated total governance costs of under one basis point. Total management and operating expenses for IDS funds in the last fiscal year were 74 basis points (0.7400%). See IDS Study Comment, *supra* note 84, at 2. (The IDS investment companies are incorporated under Minnesota law, which does not require an annual meeting of shareholders, and did not hold shareholders' meetings for a three year period.)

The independent trustees of the Scudder Funds stated that their annual compensation and other related expenses typically represent between one and two percent of a fund's total expenses. Letter from Non-Interested Trustees of Scudder Funds to Jonathan G. Katz, Secretary, SEC at 4 (Oct. 9,19901, File No. S7-11-90. For a fund with annual expenses of two percent of assets, or two hundred basis points, this means that the trustees cost between two and four basis points **as a percentage of** fund net assets.

<sup>119</sup>See *supra* note 113and accompanying text regarding the UCITS. Both the UCITS model and the UIF contemplate a pool organized under a governing document setting forth the material aspects of the pool, including the rates of fee. In both instances, assets would be kept under the custody of an established financial institution. Under the UCITS model, however, the custodian could be affiliated with the pool sponsor.

<sup>120</sup>Letter from Debevoise & Plimpton to Jonathan G. Katz, Secretary, SEC at 3 (Oct. 10, 1990), File No. 57-11-90.

<sup>121</sup>In England, for example, individuals are required to go through an extensive vetting process before being permitted to act as advisers. Once qualified, however, such advisers are subjected  
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Moreover, even if governance structures were more uniform, formidable barriers to internationalization would remain in the areas of taxation, distribution, marketing, and regulatory compliance. As discussed in Chapter 4, we believe that such barriers are best dealt with through amendments to section 7(d) of the Act<sup>122</sup> and the Internal Revenue Code.

### E. Recommendations Concerning the UIF

The TJIF has two predominant features: a single fee to cover all management expenses and the elimination of the governance structure required by the Act. Commenters generally have assumed that they are inextricably linked. We believe, however, that the link can and should be severed. As we discuss in Chapter 8, while competitive forces and ease of shareholder redemption may provide adequate discipline with respect to the single fee aspect of the UIF, they are clearly insufficient to police operational conflicts of interest. We therefore conclude that while the UIF as proposed should not be permitted, the single fee aspect of the UIF proposal has merit and should be implemented. However, governance protections, including board review of operational conflicts, should be retained for matters other than fees.

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<sup>121</sup>(...continued)

to relatively minimal regulation. In contrast, in the United States, there is no such vetting process, but advisers are required to comply with the relatively extensive requirements imposed by the Act.

<sup>122</sup>15 U.S.C. § 80a-7(d). Section 7(d) prohibits a foreign investment company from using interstate commerce to offer its shares publicly, absent an order from the Commission. Under current law, such an order can be granted only if "by reason of special circumstances or arrangements, it is both legally and practically feasible effectively to enforce the provisions of [the Act] against such company and that the issuance of such order is otherwise consistent with the public interest and the protection of investors." In Chapter 4, we recommend that section 7(d) be amended to authorize the Commission to enter into bilateral regulatory memoranda of understanding that would create a framework for regulatory cooperation and mutual recognition of investment company regulation. We propose that section 7(d) further be amended to give the Commission greater flexibility to permit foreign funds to register in the United States and to clarify, in the absence of a public offering, when section 7(d) requires foreign funds to register.

Under this recommendation, a UCITS might well qualify for registration and sale in the United States. We see no anomaly, however, in permitting such a vehicle to be sold in the United States while simultaneously refusing to implement the UIF. The harmonizing element of these two positions concerns both the protection and the expectations of investors. When investors purchase a domestic open-end fund, they expect and are afforded the protections of the governance system required by the Act. When investors buy a UCITS or other foreign fund that may qualify for sale under amended section 7(d), they will expect and will be afforded the protections provided by the laws under which such company operates – which must serve the same purposes as the protections provided by the Act -- or by specific conditions agreed to by the foreign company. The UIF provides neither the protections of the Act's governance requirements nor the similar protections of a foreign regulatory system.

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## **V. Conclusion**

The governance model embodied in the Act is sound and should be retained, with three limited modifications. First, the Division recommends certain changes that it believes will enhance the independence of investment company boards of directors without undue expense. In particular, we recommend that the minimum proportion of independent directors on investment company boards be increased from forty percent to a majority, that independent directors be given the authority to terminate advisory contracts, and that independent director vacancies be filled by remaining independent directors.

Second, to focus the responsibilities of board members into areas where they perform best -- namely exercising business judgment in conflict of interest situations -- the Division recommends eliminating provisions in certain rules under the Act that make independent directors responsible for detailed findings of fact or for reviews and findings that involve more ritual than substance. Specifically, we recommend modification or elimination of the board's functions in connection with rules 10f-3, 12d3-1, 17a-7, 17e-1, 17f-4, and 22c-1.

Third, to further streamline investment company governance, the Division recommends the elimination or modification of a number of voting requirements that we believe do not comport with the realities of modern securities markets and can no longer be justified on an investor protection basis. In particular, we recommend that investment company shareholders no longer be required to ratify the initial advisory contract and rule 12b-1 plan (if any) of a newly organized company, concur in the board's selection of auditors, or approve changes in relatively routine investment policies. Conversely, however, because we believe that an investment company's investment objective is a critical determinant of the potential risk and reward inherent in the shareholder's investment, we recommend that a requirement be added to the Act that shareholders approve any change in investment objective.

Finally, the Division recommends against implementation of the UIF because the Division believes that the UIF raises significant investor protection concerns, would not reduce costs substantially, and would not significantly promote internationalization.

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## Chapter 8

# The Sale of Open-End Investment Company Shares

### I. Introduction and Summary of Recommendations

Over the past fifty years, tremendous changes have taken place in how open-end investment companies, known as "mutual funds," sell their securities and in how the sales are regulated under the Investment Company Act<sup>1</sup>. The evolution of the current sales or "distribution" system reflects an ongoing search for the proper balance between competition and regulation. As distribution methods have changed, Congress and the Commission have had to examine the effectiveness of competition in a number of contexts. While Congress historically has preferred to rely on competition to check the level of investment company fees and expenses, Congress has substituted regulation where it determined effective competition was lacking.

Today, as in 1940, the sale of fund shares is almost always contracted out, on an exclusive basis, to a "principal underwriter," which in most cases is the adviser itself or a close affiliate. Principal underwriters typically confine themselves to wholesale transactions and leave the public selling to independent retail dealers, under sales agreements. Some principal underwriters, *e.g.*, insurance companies that own advisers, have their own retail sales organizations sometimes referred to as "captive sales forces." Captive sales forces sell primarily funds the underwriter represents or other securities issued by the underwriter and its affiliates. Most retail dealers have contracts with numerous principal underwriters and sell the shares of many different funds simultaneously.

In 1940, most investors paid a "sales load"<sup>3</sup> when they purchased shares, which was retained by the principal underwriter and the selling broker-dealer and no part of which was paid to the fund. The load was used to finance the underwriter's profit, the broker's commission, and other sales and promotional expenses.

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<sup>1</sup>Investment Company Act of 1940, 15 U.S.C. § 80a.

<sup>2</sup>See, *e.g.*, INVESTMENT COMPANY INSTITUTE ("ICI"), 1991 MUTUAL FUND FACT BOOK: INDUSTRY TRENDS AND STATISTICS FOR 1990, at 34-36 (1991) [hereinafter 1991 ICI FACT BOOK].

<sup>3</sup>Sales load is defined as the difference between the public offering price paid by investors and the current net asset value per share received by the fund, less any portion of such difference deducted for administrative expenses not properly chargeable to sales or promotional activities. See Investment Company Act § 2(a)(35), 15 U.S.C. § 80a-2(a)(35).

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This "front-end sales load" was and is expressed as a percentage of the total purchase or offering price.<sup>4</sup> For example, if the current net asset value of a fund<sup>5</sup> is \$9.15 per share and the front-end sales load is 8.5%, the public offering price will be \$10 per share. The \$0.85 sales load per share is a markup of **9.3%** on the \$9.15 per share actually invested in the fund.

In 1940, a small number of funds, called "no-load" funds, marketed their shares directly to the public, primarily through advertising, and did not charge sales loads. Their more limited sales expenses were paid by the funds' investment advisers or principal underwriters out of their own profits,

As enacted in 1940, the Investment Company Act<sup>6</sup> had few limits on the levels of sales loads or other fees. The Act included a general prohibition on unconscionable or grossly excessive sales loads, to be defined by a registered securities association, such as the National Association of Securities Dealers, Inc. ("NASD")? The Act also required that advisory services and fees be stipulated in a written contract approved initially by a fund's shareholders and directors.<sup>8</sup>

To prevent abusive trading practices that resulted from the "backward pricing" method used by funds before 1940,<sup>9</sup> the Act required that all sales of registered investment company shares be made at a fixed offering price specified in the prospectus. The base price of a mutual fund is always derived from net asset value, so this requirement fixed the *sales load* component of the public offering price. Although this provision, section 22(d),<sup>10</sup> minimized the identified

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<sup>4</sup>In contrast, sales commissions or markups in most securities transactions are expressed as a percentage of the net amount actually invested.

<sup>5</sup>The offering price of a mutual fund's shares is based on the fund's current net asset value, which is a term designating the excess of the value of portfolio securities owned, cash, receivables, and other assets of the fund over the liabilities of the fund. AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, AUDIT AND ACCOUNTING GUIDE: AUDITS OF INVESTMENT COMPANIES 209 (3d ed., revised 1987). Funds must redeem their shares at net asset value, calculated daily. Rule 22c-1, 17 C.F.R. § 270.22c-1.

<sup>6</sup>Investment Company Act of 1940, Pub. L. No. 76-768, 54 Stat. 789 (1940).

<sup>7</sup>*Id.* § 22(b), 54 Stat. 789,823 (codified as amended at 15 U.S.C. § 80a-22(b)). The NASD is the only securities association registered under section 15A of the Securities Exchange Act of 1934, 15 U.S.C. § 78o-3.

<sup>8</sup>Investment Company Act of 1940, Pub. L. No. 76-768, § 15/54 Stat. 789, 812 (codified at 15 U.S.C. § 80a-15).

<sup>9</sup>See infra notes 39-43 and accompanying text.

<sup>10</sup>15 U.S.C. § 22(d).

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trading abuses, it also made lawful a system of retail price maintenance, eliminated all secondary market trading, and impeded price competition. Thus, the Act provided that the sale of mutual fund shares is exempt from normal antitrust law principles of free competition.

In the 1960's, the Commission recommended greater regulation of sales loads and advisory fees because competition had not been an effective check on their levels.<sup>11</sup> The Commission found that retail price maintenance, the external management structure of mutual funds, and a lack of investor sophistication and influence had all interfered with competition. In effect, mutual fund fees and charges had become insulated from both competition and regulation.

In response, Congress imposed on advisers a fiduciary duty with respect to the receipt of compensation for services and also imposed on advisers a duty to furnish, and on directors a duty to evaluate, all information relevant to the review of advisory contracts.<sup>12</sup> Congress considered repealing the retail price maintenance provision, section 22(d), but deferred action pending a formal Commission study. As an interim measure, Congress gave a registered national securities association rulemaking authority to prevent "excessive sales loads." Under this authority, the NASD has imposed an 8.5% cap on front-end sales loads.<sup>13</sup>

After study, the Commission did not recommend an immediate repeal of section 22(d), but instead recommended an administrative program to allow the retail price maintenance system to be replaced over time by competition. The administrative program sought to promote efficiencies in mutual fund distribution through a gradual introduction of limited forms of retail price competition, *i.e.*, by relaxing rigid advertising rules and permitting more sales load variations.<sup>14</sup>

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<sup>11</sup>SEC, REPORT ON THE PUBLIC POLICY IMPLICATIONS OF INVESTMENT COMPANY GROWTH, H.R. REP. No. 2337, 89th Cong., 2d Sess. 126-27, 143-47, 221-23 (1966) [hereinafter PPI REPORT]. The PPI REPORT drew upon a report by the Wharton School of Finance and Commerce on mutual funds requested by the Commission (WHARTON SCHOOL OF FINANCE AND COMMERCE, A STUDY OF MUTUAL FUNDS H.R. REP. No. 2274, 87th Cong., 2d Sess. (1962) [hereinafter WHARTON REPORT]), and a Commission staff report that examined, among other things, the way in which mutual funds were bought and sold (SEC, SPECIAL STUDY OF SECURITIES MARKETS, H.R. Doc. No. 95, 88th Cong., 1st Sess., pt. 4 (1963) [hereinafter 1963 SPECIAL STUDY]).

<sup>12</sup>Investment Company Act §§ 15(c), 36(b), 15 U.S.C. §§ 80a-15(c), -35(b).

<sup>13</sup>See *infra* notes 109-110 and accompanying text.

<sup>14</sup>SEC DIVISION OF INVESTMENT MANAGEMENT REGULATION, MUTUAL FUND DISTRIBUTION AND SECTION 22(d) OF THE INVESTMENT COMPANY ACT OF 1940 at 10-16 (1974) [hereinafter 1974 DISTRIBUTION REPORT].

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In 1980, after much debate, the Commission adopted rule 12b-1, which permits funds conditionally to use their assets to make continuing payments to distributors and other sellers of fund shares.<sup>15</sup> Funds that adopt rule 12b-1 plans under the rule as a substitute for front-end sales loads typically assess charges that range today from 0.50% to 1.25% of average daily net assets to pay for sales commissions, "trail" commissions, and other distribution expenses.<sup>16</sup>

Shortly thereafter, the Commission issued the first of many exemptive orders allowing the deduction of contingent deferred sales loads ("CDSLs") upon redemption of fund shares.<sup>17</sup> CDSLs are "contingent" since they are paid only on redemptions that occur within a specified period after purchase and may be expressed as a percentage of either the original purchase price, or more typically, the redemption proceeds. Almost since rule 12b-1's inception, CDSLs have been used in combination with plans of distribution under the rule (a "spread load") as an alternative to high front-end sales loads. For example, instead of a fund charging a 6% front-end load, it could recoup roughly the same amount through a combination of an annual 1% rule 12b-1 fee and a CDSL of 6% that declined 1% per year until it reached zero at the end of the sixth year. CDSLs protect underwriters from early redemptions as the high initial outlays in commissions to a sales force are recouped over time through the rule 12b-1 fees. To some degree, spread loads have replaced high front-end loads, but they have also been criticized as "hidden loads" because they permit funds to impose high sales costs without the visibility of front-end loads.<sup>18</sup>

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<sup>15</sup>17 C.F.R. § 270.12b-1. Rule 12b-1 was adopted in Bearing of Distribution Expenses by Mutual Funds, Investment Company Act Release No. 11414 (Oct. 28, 1980), 45 FR 73898.

<sup>16</sup>See Letter of the ICI to Jonathan G. Katz, Secretary, SEC 21 (Sept. 19, 1988) File No. S7-10-88 (responding to Payment of Asset-Based Sales Loads by Registered Open-End Management Investment Companies, Investment Company Act Release No. 16431 (June 13, 1988), 53 FR 23258) [hereinafter ICI Rule 12b-1 Comment]. See also Lipper Directors' Analytical Data, Vol. I, Sec. III, Table VII Study on 12b-1 Plans (1st ed. 1992). In addition to transaction-based sales commission payments, smaller "trail commissions" are often used to compensate broker-dealers and other sellers for ongoing sales and shareholder servicing efforts. They are generally assessed either separately as service fees or are part of rule 12b-1 fees. Under the NASD proposal to regulate asset-based sales loads, service fees would be limited to 0.25% of a fund's average daily net assets. See *infra* notes 145-148 and accompanying text.

<sup>17</sup>E.F. Hutton Investment Series, Inc., Investment Company Act Release Nos. 12079 (Dec. 4, 1981), 46 FR 60703 (Notice of Application) and 12135 (Jan. 4, 1982), 24 SEC Docket 647 (Order).

<sup>18</sup>See, e.g., Albert B. Crenshaw, *New Rules Drafted for Mutual Funds*, Wash. Post, Jun. 19, 1988, at H3 and Letter from Charles Trzcinka to Jonathan G. Katz, Secretary, SEC 1 (May 23, 1991), File No. SR-NASD-90-69 (responding to Notice of Proposed Rule Change by National Association of Securities Dealers, Inc. Relating to the Limitation of Asset-Based Sales Charges as Imposed by Investment Companies, Exchange Act Release No. 29070 (Apr. 12, 1991), 56 FR 16137).

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In 1988, because of concern about the open-ended nature of rule 12b-1 fees as well as their "opaqueness," the Commission proposed amendments to rule 12b-1 that, in effect, would have precluded spread loads<sup>19</sup>. Shortly thereafter, the Commission proposed rule 6c-10 to permit not only CDSLs but also deferred loads generally as an alternative to spread loads.<sup>20</sup> In response to those initiatives, the **NASD** proposed amendments to regulate rule 12b-1 fees and CDSLs under its maximum sales load rule.<sup>21</sup> The three proposals are still outstanding.

Two other regulatory developments deserve brief mention. In 1985, the Commission by rule permitted funds to schedule variations in, or eliminate, front-end sales loads.<sup>22</sup> More recently, the Commission has issued a number of exemptive orders permitting funds to issue multiple classes of securities, each subject to a different distribution arrangement, but representing interests in the same portfolio of investments.<sup>23</sup>

The fund industry's explosive growth and diversity in the 1980's is partially attributable to the changes in the regulation of the marketing of funds, especially the relaxation of restrictions on investment company advertising. Of course, favorable market conditions and changes in the financial services industry are other important factors in the decade's record level of sales.<sup>24</sup>

As the fund industry has grown and diversified, the channels of mutual fund distribution have expanded. Generally, the distribution of funds in the individual investor market still may be divided into two main channels: shares sold by direct marketing and shares sold by commissioned sales forces. Direct marketers offer shares to investors through the mail, or by telephone, or at fund offices. Commissioned sales forces are used by securities firms and, in addition,

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<sup>19</sup>Inv. Co. Act Rel. 16431, supra note 16.

<sup>20</sup>Exemptions for Certain Registered Open-End Management Investment Companies to Impose Deferred Sales Loads, Investment Company Act Release No. 16619 (Nov. 2, 1988), 53 FR 45275.

<sup>21</sup>See *infra* notes 149-150 and accompanying text.

<sup>22</sup>Investment Company Act rule 22d-1, 17 CFR. § 270.22d-1. Rule 22d-1 was adopted in Exemption from Section 22(d) to Permit the Sale of Redeemable Securities at Prices That Reflect Different Sales Loads, Investment Company Act Release No. 14390 (Feb. 22, 1985), 50 FR 7909.

<sup>23</sup>See *infra* notes 171-174.

<sup>24</sup>See ICI, A DECADE OF GROWTH, PERSPECTIVE ON MUTUAL FUND ACTIVITY 20-27 (Spring 1990) [hereinafter DECADE OF GROWTH]. Changes in pricing structures, restructuring of distribution channels, increased emphasis on promotion and public relations, and heightened awareness of investor needs also have contributed to this **growth**. Id.

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financial planners, life insurers, and depository institutions. In the past two decades, direct-marketed funds have come to represent a significant part of mutual fund distribution. In 1990, direct-marketed funds had sales of \$51.8 billion, or thirty-five percent of stock, bond, and income fund sales, while funds sold through sales forces accounted for \$90.2 billion, or sixty percent of stock, bond, and income fund sales.<sup>25</sup>

Investors today may select among a variety of methods to finance the purchase of shares. While the number of funds using high front-end sales loads certainly has decreased<sup>26</sup> and funds have moved to rule 12b-1 fees, it is not clear whether investors' costs have in fact been lowered as a result of these changes.<sup>27</sup> Many of the factors recognized as impeding competition in the 1960's, such as retail price maintenance, still exist. Additionally, the increasing complexity and variety of sales and other charges may interfere with competitive pressures on fee levels. Thus, the major distribution issue facing the Commission continues to be the degree and effect of competition in the mutual fund industry.

Three factors are critical to the dynamics of distribution and the interplay of regulation and competition on distribution pricing.<sup>28</sup> First, the open-end nature of mutual funds gives rise to the tremendous and continuous pressures to

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<sup>25</sup>Other sales result from reinvested dividends in funds no longer offering shares and from variable annuities. **1991 ICI FACT BOOK**, supra note 2, at 37.

<sup>26</sup>In response to the Commission's request for comments on investment company regulation (Request for Comments on Reform of the Regulation of Investment Companies, Investment Company Act Release No. 17534 (June 15, 1990), 55 FR 25322 [hereinafter Study Release]), the ICI indicated that "the number of funds with a maximum sales load of 8.5 percent has decreased dramatically (from 341 funds with 80 percent of assets in 1972 to 159 funds with 60 percent of assets in 1983, and to 60 funds with 18 percent of assets in 1990)." Letter from the ICI to Jonathan G. Katz, Secretary, SEC 50 n.40 (Oct. 5, 1990), File No. S7-11-90 [hereinafter ICI Study Comment]. Of course, the nature of funds sold has changed markedly. For example, money market funds (including tax-exempt money-market funds), which typically charge little or no loads and did not exist until the early 1970's, accounted for 744 funds with 47% of mutual fund assets in 1990. **1991 ICI FACT BOOK**, supra note 2, at 45, 74.

<sup>27</sup>A result of this repositioning, however, is that average fund expense ratios in certain segments of the industry, e.g., equity and taxable fixed income funds, have risen over the past decade. This is largely because rule 12b-1 fees are an annual fund expense that are included in the ratio while front-end sales loads are not.

<sup>28</sup>The Commission requested comment on the broad questions of whether the present regulatory approach should be changed and whether retail price competition would reduce the need for regulatory limitations, and encouraged commenters to consider any alternative approaches used by other pooled investment vehicles. See Study Release, *supra* note 26, at § III.D. The Commission received over 90 comment letters on these topics, including almost 60 from individual investors. For the most part, industry related commenters favored the status quo, while individual investors believed that fees should be made simpler and more comparable.

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sell new shares in order to offset redemptions (otherwise, funds are said to be in a state of "net redemption"). Second, the external management structure of investment companies brings with it certain built-in conflicts of interest in the pricing of advisory and other services provided to funds and in the decision to spend fund assets to promote distribution. Third, because funds may finance distribution costs through various methods, including sales loads, rule 12b-1 fees, advisory fees, and underwriting fees,<sup>29</sup> regulation of one method inevitably affects the others.

The Division has considered various ways to modify the present regulatory approach in light of these factors. Our recommendations focus on eliminating impediments to vigorous price competition, increasing investor understanding of total investment costs, promoting cost comparability among funds, and easing restrictions so that funds may experiment with distribution arrangements that make costs more explicit. We believe these changes would promote price competition and result in more economical and efficient distribution methods.

First, the Division recommends that the Commission seek legislation to amend section 22(d) to unfix front-end sales loads. This action would introduce price competition among dealers. In addition, repeal of the price maintenance provision could facilitate the creation of new and innovative securities products that depend on free secondary markets.

Second, the Division recommends several rule changes to address the variety of alternative distribution arrangements that have developed in the past decade. We generally endorse the concept of extending the NASDs maximum sales charge rule to rule 12b-1 fees and CDSLs on the same basis as front-end sales loads. NASD regulation of these charges is consistent with our view that regulation should be substituted where competition is ineffective; price competition cannot be relied upon to check the size of spread loads since those fees often are confusing and opaque to investors. We recommend that the Commission adopt a limited portion of the amendments to rule 12b-1 proposed in 1988. The amendments should clarify certain requirements for funds financing distribution through fund assets, including use of a spread load. In addition, we recommend that the Commission adopt the rule proposed in 1988 to permit deferred sales loads, including installment loads, with slight modifications. Finally, we recommend proposing a new rule that would codify existing exemptive orders permitting funds to offer shares in multiclass structures. This action would expand investor choice in the methods of financing distribution and eliminate the costs funds now bear of seeking individual exemptive orders.

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<sup>29</sup>Before 1975 and the repeal of fixed commissions, fund brokerage commissions (in reciprocal and "customer-directed give-up" practices) were another important source of additional compensation for retailers selling mutual funds. PPI REPORT, *supra* note 11, at 162-72.

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Third, the Division recommends that the Commission propose legislation to permit the introduction of an optional form of mutual fund with a simplified method of distribution financing: a unified fee investment company ("UFIC"). This type of fund would have a single fee, prominently disclosed, out of which the sponsor would pay all fund expenses other than extraordinary expenses and brokerage. No separate sales loads or distribution charges would be imposed. UFIC fee levels would be market-based and not subject to regulatory limits, other than a general prohibition on unconscionable or grossly excessive fees.

Section II of this chapter discusses the relationship between sales load levels and retail price maintenance and our recommendation to amend section 22(d) of the Act. Section III details the various methods currently available for distribution financing and our recommendations for change. Section IV discusses our recommendations for the UFIC.

## 11. Sales Loads and Retail Price Maintenance

Section 22(d) of the Act prohibits registered investment companies, their principal underwriters, and dealers in their redeemable securities from selling such securities except at a current public offering price described in their prospectus.<sup>30</sup> Thus, section 22(d) effectively prohibits price competition in sales loads on mutual fund shares at the retail level. Together with section 22(f), which permits mutual funds to impose restrictions on the transferability or negotiability of their shares, section 22(d) confers federal antitrust immunity for retail price maintenance and mutual fund distribution restrictions.<sup>31</sup>

Over the years, section 22(d) has been the subject of considerable analysis and debate. Many have argued that it effectively has raised investors' costs without compensating benefits.<sup>32</sup> Others have maintained that retail price maintenance is so fundamental to the distribution of the shares of open-end

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<sup>30</sup>Investment Company Act section 2(a)(29) (15 U.S.C. § 80a-2(a)(29)) defines a principal underwriter for an open-end investment company to be any underwriter who as principal purchases from such company securities for distribution, or as agent for such company sells such securities to a dealer or the public or both. Section 2(a)(40) defines an underwriter to be any person who purchases from an issuer with a view to distribution. Section 2(a)(11) defines a dealer to be any person engaged in buying and selling securities for his own account as part of a regular business.

<sup>31</sup>United States v. National Ass'n of Sec. Dealers, Inc., 422 U.S. 694 (1975).

<sup>32</sup>See, e.g., PPI REPORT, *supra* note 11, at 221; Hearings on S. 1659, Before the Senate Comm. on Banking and Currency, 90th Cong., 1st Sess. 665 (1967) [hereinafter 1967 Senate Hearings] (statement of Professor Irwin Friend, one of the principal authors of the Wharton Report).

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companies that its elimination would have a profoundly harmful impact on the industry and investors.<sup>33</sup>

Today, there no longer seems to be any basis for restricting retail price competition in mutual fund distribution. Developments in the last fifty years, most notably the introduction of mandatory forward pricing, have eliminated the original rationales for retail price maintenance. Moreover, the strength and creativity of the investment company industry make it unlikely that further competition would harm investors. Indeed, there is reason to believe that price competition would benefit investors, as it benefits consumers of other goods and services. Accordingly, the Division recommends amending section 22(d) to end retail price maintenance.

#### A. The Purposes of Section 22(d)

Section 22(d) departs from the usual congressional policy, expressed in the antitrust laws, against price fixing.<sup>34</sup> The legislation proposed by the Commission in 1940 contained no such provision? it was first suggested by industry representatives **and** set forth in a memorandum of agreement between those representatives and the Commission that was drafted after the Senate hearings on the initial bill.<sup>36</sup> Although the legislative history contains little explanation of the purpose of section 22(d), retail price maintenance does not

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<sup>33</sup>See, e.g., **1967 Senate Hearings**, *supra* note 32, at 665 (statement of the ICI); **1974 DISTRIBUTION REPORT**, *supra* note 14, at 51-53 (written comment of the ICI).

<sup>34</sup>Sherman Antitrust Act (15 U.S.C. § 1) and Federal Trade Commission Act (15 U.S.C. § 41). Although there is some difference in the standard, horizontal and vertical agreements to restrict resale prices are considered illegal *per se* and generally prosecuted as felonies under Sherman Act section 1. See, e.g., *Business Elect. Corp. v. Sharp Elect. Corp.*, 485 U.S. 717 (1988); *Monsanto Co. v. Spray-Rite Serv. Corp.*, 465 U.S. 752 (1984); *United States v. U.S. Gypsum Co.*, 438 U.S. 422 (1978).

<sup>35</sup>Section 22 of the proposed legislation contained two subsections addressing dilution. Subsection (a) would have permitted the Commission to prescribe pricing rules for the purpose of eliminating or reducing dilution. Subsection (b) would have provided that no underwriter or dealer, in a primary distribution, could purchase securities from a registered investment company or underwriter except at the price at which it sold such securities, less a commission or spread allowed by the seller. S. 3580, 76th Cong., 3d Sess., § 22, at 48-50 (Mar. 14, 1940). See *Investment Trusts and Investment Companies: Hearings on S. 3580, Before a Subcomm. of the Senate Comm. on Banking and Currency*, 76th Cong., 3d Sess. 15 (1940) [hereinafter 1940 Senate Hearings].

<sup>36</sup>*Id.* at 1057.

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itself appear to have been the purpose of the section.<sup>37</sup> Rather, the legislative history suggests that Congress intended retail price maintenance simply as a means of preventing certain activities that existed in the distribution of mutual fund shares before 1940: riskless trading by insiders and resulting dilution, disruption of distribution systems, and unjust discrimination.<sup>38</sup>

## 1. Riskless Trading by Insiders

The first activity to which we believe section 22(d) was primarily addressed was riskless trading by insiders and the resulting dilution of fund assets.<sup>39</sup> Under the system of backward pricing generally used before the Act's passage and for many years thereafter, the price of a mutual fund share was based upon the fund's net asset value per share determined at the close of the market on the previous day. If the market rose, an investor could purchase fund shares near the end of the day at the price based upon the previous day's valuation, knowing that the actual net asset value of the shares was greater than the price he or she was paying.<sup>40</sup> The transaction could be made riskless by redeeming the shares the following day, before a new and possibly lower price reflecting that day's market activity was established.<sup>41</sup>

For most investors, payment of a sales load made riskless trading unprofitable, since a load generally would more than offset any profit that could result from one day's increase in the value of a fund's shares. Insiders and favored customers, however, often could purchase fund shares without paying

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<sup>37</sup>If section 22(d) was intended as a retail price maintenance provision, it seems reasonable to expect some discussion on that point. Yet, for example, there was no mention of retail price maintenance in a Commission representative's analysis of the final bill. *Hearings on H.R. 10065 Before the House Comm. on Interstate and Foreign Commerce*, 76th Cong., 3d Sess. 124 (1940) [hereinafter 2940 House Hearings] (testimony of David Schenker, Chief Counsel, Investment Trust Study).

<sup>38</sup>A complete legislative and administrative history of section 22(d) was prepared as an appendix to the release proposing rule 22d-6 which was later adopted as rule 22d-1. See Exemption From Section 22(d) To Permit the Sale of Redeemable Securities at Prices That Reflect Different Sales Loads, Investment Company Act Release No. 13183 (Apr. 22, 1983), 44 FR 19887, 27 SEC Docket 1353 (May 10, 1983)(Appendix).

<sup>39</sup>Some commentators have suggested that the only abuse that Congress addressed in section 22(d) was dilution. See James V. Heffernan & James F. Jorden, *Section 22(d) of the Investment Company Act of 1940 – Its Original Purpose and Present Function*, 1973 DUKE L.J. 975, 984-93.

<sup>40</sup>1940 Senate Hearings, *supra* note 35, at 138-141 (statement of Baldwin Bane, Director, SEC Registration Division).

<sup>41</sup>*Id.* at 289 (statement of David Schenker).

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sales loads.<sup>42</sup> Since the overwhelming majority of open-end funds in 1940 Act were front-end load funds, the enactment of section 22(d) reduced the degree of dilution occurring from such riskless trading practices by requiring all investors to pay the same sales load.<sup>43</sup>

## 2. Disruption of Orderly Trading

The second activity was the creation of unauthorized secondary markets which was said to cause the disruption in the orderly distribution of mutual fund shares.<sup>44</sup> Before 1940, authorized dealers that distributed a fund's shares generally were bound by contract with the principal underwriter to charge the single price described in the prospectus and were not given the discretion to lower prices to meet competition from non-contract dealers. Non-contract dealers were able to purchase shares for slightly more than the published redemption price and to offer the shares for slightly less than the published sales price. Because authorized dealers could not compete with non-contract dealers, an active secondary market developed, the so-called "bootleg market."<sup>45</sup> This bootleg market resulted in the cancellation of many selling agreements between

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<sup>42</sup>See SEC, INVESTMENT TRUSTS AND INVESTMENT COMPANIES, H.R. Doc. No. 279, 76th Cong., 1st Sess., pt. 3, 862 (1940) [hereinafter INVESTMENT TRUST STUDY]. See 1940 Senate Hearings, *supra* note 35, at 289.

<sup>43</sup>The Commission would have cured riskless trading by requiring forward pricing. The industry, however, vigorously resisted, and section 22(d) as enacted was the compromise modeled on an Ohio securities provision that was designed to address insider riskless trading. See 1940 Senate Hearings, *supra* note 35, at 523, 526-27, 859.

<sup>44</sup>See INVESTMENT TRUST STUDY, pt. 3, *supra* note 42, at 865. See also United States v. National Ass'n of Sec. Dealers, Inc., 422 U.S. 694, at 714-15 (1975); PPI REPORT, *supra* note 11, at 219; Survey, *The Mutual Fund Industry: A Legal Survey*, 44 NOTRE DAME LAW. Rev. 732, 850 (1969); and Lawrence M. Greene, *The Uniform Offering Price of Mutual Fund Shares Under the Investment Company Act of 1940*, 37 U. DET. L.J. 369, 371-72 (1960). But see Heffernan & Jorden, *supra* note 39, at 990, 996-97 (suggesting that this was a *post facto* argument with no basis in the legislative history).

<sup>45</sup>INVESTMENT TRUST STUDY, pt. 3, *supra* note 42, at 809, 856-57, and 865 ("Such operations actually had the effect of initiating a small scale price war between retailers and tended generally to disrupt the established offering price"). See Greene, *supra* note 44; 4 TAMAR FRANKEL, THE REGULATION OF MONEY MANAGERS 10, 42, 90 (1978 & Supp. 1990). See also INVESTMENT TRUST STUDY, pt. 3, 809, 857 (noting the existence of a secondary market maintained by contract dealers, which apparently was stronger and more active, and contending the principal abuse within that market was not disruption of the offering price but rather the riskless profit obtained by contract dealers as a result of the backward pricing system).

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contractual dealers and underwriters and threatened the contractual distribution system.<sup>46</sup>

Members of the industry have over the years, argued that an "orderly" distribution system under the control of fund underwriters facilitates the ability of mutual funds to offer constant redemption of their shares.<sup>47</sup> They have long urged that mutual fund distribution has a unique status because fund shares are redeemable at any time at the option of holders, making funds naturally shrinking entities. They have argued that net redemption status makes portfolio management difficult and can be prevented only by active sales of new shares; thus, secure dealer compensation is perceived as critical to the vitality of the fund industry. They also have argued that firms might suffer if non-contract dealers accumulated large blocks of shares and then, because of market fluctuations, redeemed them.<sup>48</sup>

A related argument for preserving retail price maintenance is that without section 22(d) non-contract dealers would bypass the primary distribution system, thereby avoiding paying their "fair share" of the promotional costs of the underwriter, giving the dealers an unfair advantage.<sup>49</sup>

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<sup>46</sup>In 1975, the Commission argued that preservation of orderly distribution by eliminating secondary market competition from non-contract dealers was a probable aim of section 22(d). Amicus Brief for the SEC at 43-44, United States v. National Ass'n of Sec. Dealers, Inc., 422 U.S. 694 (1975). The Commission pointed to the fact that, before the passage of the final bill, secondary market dealers apparently alerted the Commission and the Senate to the consequences of section 22(d) to their business in an unsuccessful attempt to have that section amended. The non-contract dealers complained in a memorandum that the section was designed to "effectively hamper [non-contract] . . . dealers in dealing in trust shares, concentrate such transactions in the hands of authorized dealers and principal underwriters, and thus create a virtual monopoly." Id. at n.95.

<sup>47</sup>See, e.g., Statement of the ICI on the Potential Impact of the Repeal of Section 22(d) of the Investment Company Act of 1940 and on Other Matters Dealing with Distribution of Mutual Fund Shares 31-34 (Feb. 2, 1973, File No. 4-164 (Hearings on Mutual Fund Distribution and §22(d) of the Investment Company Act of 1940); 1974 DISTRIBUTION REPORT, *supra* note 14, at 52 (written comment of the ICI) ("ability of fund sales to keep pace with redemptions would be endangered" by the lowering of sales incentives to salesmen resulting from secondary market influences). But see Comments of the U.S. Dep't of Justice 35 (Feb. 2, 1973), File No. 4-164 [hereinafter 1973 Justice Department Comment] (contending this rationale is "sheer gloss on the legislative history" with the "patina of age upon the continued urging of the ICI").

<sup>48</sup>See 1974 DISTRIBUTION REPORT, *supra* note 14, at 53 (testimony of Carl Frischling, Channing Management Corporation).

<sup>49</sup>This line of argument is sometimes raised in antitrust cases dealing with distribution restraints, but courts have rejected such "unfair cost burden" arguments in favor of a rule which holds that such restraints are *per se* violations of the law. See, e.g., 1973 Justice Department Comment, *supra* note 47, at 38 ("The *per se* rule is based on a recognition that the potential benefits (continued...)")

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### **3. Unjust Discrimination**

The third phenomenon arguably addressed by section 22(d) was discrimination among investors resulting from a fund charging different prices to different investors. While commentators have differed on whether the purpose of section 22(d) was to address such price discrimination, the Commission has cited it as such.<sup>51</sup> At the same time, however, the section has never been considered to require the same percentage load on every purchase, so long as variations (*e.g.*, quantity discounts) available to one purchaser also are available to the next.<sup>52</sup> Indeed, in 1966, the Commission expressed concern that retail price maintenance is unfair if investors requiring different levels of sales efforts must be charged the same sales load.<sup>53</sup> Today, any scheduled variation in front-end loads to particular classes of investors is permitted, if it is disclosed.<sup>54</sup> Alternatively, some have argued that the "investor discrimination" aimed at was not price discrimination, but discrimination that allowed favored "insider" purchasers to exploit backward pricing.<sup>55</sup>

#### **B. Commission Action under Section 22(d)**

Since 1940, the Commission has addressed the effect of section 22(d) on the pricing and distribution of mutual fund shares both in numerous reports and in rulemaking. The prevailing theme has been that retail price maintenance, as well

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<sup>49</sup>(...continued)

of a market system where all dealers are free to buy from and sell to whomever they chose, at any price agreed upon, are more readily apparent than speculative disadvantages to the primary distributors and dealers forced to compete with the discounters.). *See also VAN CISE AND LIFLAND, UNDERSTANDING THE ANTITRUST LAWS 120-123,126-27 (1980).*

<sup>50</sup>Compare Greene, *supra* note 44, at 371 (citing, among other factors, prevention of discrimination as a purpose "well known in the industry and to the Commission"), with Heffernan & Jorden, *supra* note 39, at 990 (arguing that legislative history does not support prevention of discrimination as a rationale). Unjust discrimination appears first to have been cited in a 1941 opinion of the Commission's General Counsel rather than in the legislative history (Investors Diversified Servs., Investment Company Act Release No. 89 (Mar. 13,1941)). But see Heffernan & Jorden, at 994 (also suggesting that the discrimination referred to in the 1941 opinion involved the potential for insiders to obtain riskless profits, *i.e.*, the insider riskless trading abuse).

<sup>51</sup>The language of section 22(d) suggests that Congress contemplated that more than one offering price could be charged different investors since the section requires sales at "a current public offering price described in the prospectus" rather than "the price."

<sup>52</sup>PPI REPORT, *supra* note 11, at 221.

<sup>53</sup>Investment Company Act rule 22d-1.

<sup>54</sup>Heffernan & Jorden, *supra* note 39, at 993.

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as inefficient distribution methods, have led to high sales costs for investors. While the Commission generally has viewed competition as the antidote to high costs and has questioned the need for section 22(d), it has not to date pursued outright repeal of the section.

The issue of retail price maintenance was highlighted in the Commission's **1966** report, entitled "The Public Policy Implications of Investment Company Growth" ("PPI Report"), on the adequacy of investor protections under the Act. The Commission concluded that, because section 22(d) prohibits competition among retail dealers, competition among distributors (principal underwriters) had the effect of raising rather than lowering mutual fund share prices to investors. Underwriters, instead of competing for sales through lower sales loads to investors, competed for the favor of the retailers who sold the shares by increasing the sales loads and thus the retailers' compensation.<sup>55</sup> The PPI Report stated that:

[t]his reflects the industry view that mutual fund shares are sold, not bought. Retail dealers in and salesmen of fund shares are viewed as the key figures in the distribution process . . . .

In a freely competitive market the load-raising effects of the vigorous competition among principal underwriters for the favor of dealers and salesmen could be restrained by countervailing downward pressures stemming from price competition among retailers for investor patronage. By precluding price competition at the retail level, section 22(d) suppresses the downward pressures that normal market forces might otherwise exert.<sup>56</sup>

While citing advantages to the repeal of section 22(d), the Commission ultimately recommended a fixed maximum sales load, principally to avoid any "unsettling and unforeseeable effects" repeal might have in the broker-dealer community while still reducing investors' sales costs.<sup>57</sup>

In 1970, Congress considered repealing section 22(d), but decided that it lacked sufficient information concerning the economic impact of repeal. The

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<sup>55</sup>PPI REPORT, *supra* note 11, at 208-09, 221.

<sup>56</sup>*Id.* at 221.

<sup>57</sup>*Id.* at 222-23. The Commission noted that the industry had accommodated itself to a system of retail price maintenance and that immediate repeal might disrupt distribution networks, harming investors' access to funds; the report instead recommended a maximum sales load of five percent.

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Commission was directed to study the matter and report back.<sup>58</sup> As a more immediate solution, Congress amended section 22(b) to give rulemaking authority to a registered securities association, *i.e.*<sup>59</sup> the NASD, to prevent excessive sales loads, subject to Commission oversight.<sup>59</sup>

In 1972, the Commission submitted to Congress a report concerning the economic impact of repeal of section 22(d). The report was an analytical study that made no recommendations for legislative or administrative action. It disputed, however, the "disruption of distribution systems" argument; and the transmittal letter by Chairman Casey stated that the findings "certainly suggest there is no compelling public interest in continued retail price maintenance in this field and that the repeal of section 22(d) would on balance be desirable."<sup>60</sup>

Subsequent public hearings provided an opportunity for an in-depth exploration of mutual fund distribution and its regulation.<sup>61</sup> A very different picture of the mutual fund industry emerged from the 1973 hearings from that described in the Commission's 1966 PPI Report. Net redemptions had replaced the record sales the industry had enjoyed earlier.<sup>62</sup> Funds had lost ground with their traditional best customers, the small investors. In addition, the industry faced a number of disruptions to its marketing system. Competing products, such as variable annuities, real estate investment trusts, and oil and gas drilling funds, had made substantial inroads because they were often easier to sell and compensation to the broker-dealers was as high or higher than for mutual funds. Within the industry itself, "load" funds were losing sales to "no-load" funds. Fund

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<sup>58</sup>S. REP. NO. 184, 91st Cong., 1st Sess. 7-8 (May 21, 1969).

<sup>59</sup>The NASD enacted a maximum sales load rule that generally limits loads to 8½% of the offering price. See *infra* text accompanying note 110.

<sup>60</sup>REPORT OF THE SEC STAFF ON THE POTENTIAL ECONOMIC IMPACT OF A REPEAL OF SECTION 22(d) OF THE INVESTMENT COMPANY ACT OF 1940, at iii-vi (1972). Among other conclusions, the report found that: repeal would result in lower acquisition costs for many fund investors, although it was unlikely the very small investor (accounts of less than \$1,000) would see any immediate benefit; reductions in fund sales charges would have an extremely modest impact on the securities industry and on most retail sellers of fund shares, except for the 13% of the broker-dealer community that obtained most of their gross revenue from sales of funds; repeal was unlikely to lead to protracted net redemptions on an industry-wide basis because any lessening of sellers' incentives would be offset to some extent by the diminished sales resistance normally associated with lower prices (citing the recent growth of the no-load sector); and concern over adverse consequences (end-running existing distribution procedures) that might result from the development of a secondary market seemed exaggerated.

<sup>61</sup>Bearing of Distribution Expenses by Mutual Funds, Investment Company Act Release No. 9470 (Oct. 4, 1976), 41 FR 44770 (announcing public hearings).

<sup>62</sup>1974 DISTRIBUTION REPORT, supra note 14, at 19.

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distribution, seldom profitable, had become even less profitable, requiring greater subsidization of distribution from advisory profits.<sup>63</sup>

In this environment, the Commission did not recommend immediate repeal of retail price maintenance in its report to Congress.<sup>64</sup> The report concluded that, due to a lack of investor sophistication and price sensitivity, the industry would need to cultivate public demand and diminish its historic reliance on intensive personal selling efforts in order to avoid widespread disruption in the fund distribution system that might otherwise occur with an immediate repeal of section 22(d). The Commission decided to lay the groundwork for a gradual and orderly introduction of price competition through administrative action that would permit funds to adopt voluntarily pricing programs designed to foster retail competition. The report also recommended that Congress amend section 22(d) to expand the Commission's authority to take further steps toward "the ultimate goal of retail price competition."<sup>65</sup>

Since announcing that program, the Commission has taken a number of steps toward modifying regulation of sales loads and mutual fund distribution generally, including easing restrictions on mutual fund advertising,<sup>66</sup> permitting funds to finance distribution expenses out of their assets,<sup>67</sup> and adopting rules and issuing orders exempting some practices from section 22(d).<sup>68</sup> In 1983, the

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<sup>63</sup>*Id.* at 17-43. In addition, the poor performance of the equity markets (in contrast to the "go-go" boom of the late 1960's) coupled with rising interest rates likely turned many investors to more secure products. *Id.* at 28/39.

<sup>64</sup>1974 DISTRIBUTION REPORT, *supra* note 14, at 76-83.

<sup>65</sup>*Id.* at 11.

<sup>66</sup>See Chapter 9.

<sup>67</sup>By adopting rule 12b-1, *supra* note 15.

<sup>68</sup>Rules 22d-1 through 22d-5 were adopted pursuant to this program. See Variations in Sales Load Permitted for Certain Sales of Redeemable Securities, Investment Company Act Release No. 2798 (Dec. 2, 1958), 23 FR 9603 (adoption of rule 22d-1); Sales of Redeemable Securities Without a Sales Load Following Redemption, Investment Company Act Release NO. 8235 (Feb. 20, 1974), 39 FR 8321 (adoption of rule 22d-2); Variable Annuities, Adoption of Exemptive Rules, Investment Company Act Release No. 8878 (Aug. 7, 1975), 40 FR 33970 (adoption of rule 22d-3); Mergers and Consolidations Involving Registered Investment Companies, Investment Company Act Release No. 11053 (Feb. 19, 1980), 45 FR 12408 (adoption of rules 22d-4 and 22d-5). With the exception of rule 22d-3 (re-numbered rule 22d-2 (17 CFR. § 270.22d-2) and applicable to insurance products), they were subsequently rescinded with the adoption of rule 22d-1 (originally proposed as rule 22d-6). From 1974 through 1983, the year rule 22d-1 was adopted, the Commission received approximately 20 applications annually requesting exemptive relief from section 22(d) and the rules thereunder.

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Commission proposed rule 22d-6, to permit all funds broad latitude to vary sales loads.<sup>69</sup> Under the rule as proposed, funds could establish a single public offering price; a schedule of fixed but different prices applicable in different transactions; or a system of unfixed prices arrived at by negotiation with purchasers. The majority of commenters (mostly industry members) expressed opposition to the negotiation aspect, positing potential market injury (concentration and disruption of distribution systems arguments), attacking the Commission's statutory authority to permit negotiated loads, and suggesting that permitting negotiation would eliminate antitrust immunity for fixed pricing of fund shares.

In 1985, the Commission adopted a revised rule permitting scheduled variations of prices, but dropping the provision allowing negotiation of prices.<sup>70</sup> The rule opened the way for all funds to sell their shares at prices that reflected different front-end sales loads, subject to the requirements that any variation be uniformly applied to all offerees in the class specified, that variations be described in the prospectus, and that current shareholders be advised within one year of any new sales load variations. While the Commission did not explain why it dropped the negotiation provision, concern over the Commission's authority was a primary factor, rather than a change in point of view about the policy.

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### C. Amendment of Section 22(d) to End Mandatory Retail Price Maintenance

The Division recommends amendment of section 22(d) to end retail price maintenance. This change would permit the development of retail price competition among dealers and the development of secondary markets in mutual fund shares.

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Our recommendation is based on the general principle that the public benefits from free and vigorous price competition. Accordingly, an anticompetitive provision such as section 22(d) should be retained only if there is a convincing public policy rationale. As discussed below, since 1940 and even since the 1970's, changing circumstances, reflecting both regulatory and marketplace developments, have eliminated the rationales that apparently prompted enactment and retention of section 22(d). If the industry did need a transition period before section 22(d) could be amended or repealed, the past

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<sup>69</sup>Inv. Co. Act Rel. 13183, *supra* note 38.

<sup>70</sup>Inv. Co. Act Rel. 14390, *supra* note 22.

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decade and a half has served that purpose.<sup>71</sup> There no longer are any compelling reasons to retain retail price maintenance.

## **1. Disappearance of Original Rationales for Retail Price Maintenance**

The first, and we believe the primary, purpose of section 22(d) has been rendered moot. Riskless trading by fund insiders to the dilution of other shareholders has not been possible since **1968**, when the Commission adopted rule 22c-1, requiring "forward" pricing of fund shares.<sup>72</sup>

Nor is it likely that the introduction of retail competition would disrupt orderly distribution of mutual fund shares, another rationale for section 22(d). The "orderly distribution" point rests on two interrelated arguments: that orderly distribution gives "secure compensation" to the sellers of mutual fund products,<sup>73</sup> and that an active secondary market would threaten that compensation.<sup>74</sup> These arguments assume that only with the assurance of a fixed commission will a securities sales representative make the effort necessary to persuade an ordinary investor to buy shares. This ignores the vast changes in

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<sup>71</sup>For example, since adoption of rule 22d-1, funds have established a variety of scheduled variations in sales loads. By the ICI's assessment, the industry seems to be in a position to meet the demands of a competitive marketplace. DECADE OF GROWTH, *supra* note 24, at 8. ("Despite rising competition from other financial institutions, mutual funds entered the decade of the **1990's** in excellent shape. The very size of assets now under management, in the vicinity of \$1 trillion, virtually assures substantial additions to the asset base from reinvested dividends. . . . The most important secular economic and demographic trends, as they appear at the beginning of the decade, look quite favorable for investment in general, and mutual fund investing in particular.").

<sup>72</sup>Investment Company Act rule 22c-1. Under forward pricing, redemptions are effected at a price based on the net asset value next computed after receipt of an order, typically at the close of the United States securities markets. See Pricing of Redeemable Securities for Distribution, Redemption and Repurchase and Time-Stamping of Orders by Dealers, Investment Company Act Release No. **5519** (Oct. 16, 1968), 33 FR **16331**.

<sup>73</sup>In responding to the Study Release, the ICI concluded, as it had in earlier submissions spanning two decades, that the purpose of section 22(d) was to assure a stable, systematic, and ongoing sales effort at the retail level. ICI Study Comment, *supra* note 26, at **49-51**.

<sup>74</sup>Some members of the industry have conceded that, under the right set of circumstances, section 22(d) could be repealed. See, e.g., **1974 DISTRIBUTION REPORT**, *supra* note 14, at 60 (statement of Robert Loeffler, Senior Vice President, Investors Diversified Services) (opining that as the public became more familiar with funds, salesmen would produce higher sales volumes for the same amount of time, thus permitting a reduction of commission rates so that such rates ultimately might be "competitive with what the spread might be on just a shelf product, which it would be in the secondary market, at which point you could repeal 22(d) and it probably wouldn't make any difference because your levels would be the same").

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public awareness and acceptance of mutual funds in the last twenty years?" The size and visibility of the fund industry and the increasing market share captured by direct-marketed funds today belie the assumption that "funds are sold not bought."

In addition, we agree with the prediction made by the Department of Justice almost twenty years ago that lower sales loads would increase, rather than decrease, sales.<sup>76</sup> In the 1973 hearings, the Justice Department argued that "[t]he Supreme Court has noted that ruinous competition, financial disaster, evils of price cutting and the like appear throughout our history as ostensible, albeit unpersuasive, justifications for price-fixing."<sup>77</sup>

The related concern that non-contract dealers might "free ride" by not paying their fair share of promotional costs carries far less weight today than it might have in 1940.<sup>78</sup> A secondary market probably would not eliminate the benefit to a principal underwriter of promoting the fund where there is affiliation between the underwriter and the investment adviser, as is true of many funds today. Underwriting of mutual funds has not been profitable historically, and

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<sup>75</sup>The ICI has said that "[i]ncreased demand for mutual funds has resulted not only from these market changes but also from the public's increased awareness of funds. Industry research shows that the awareness of mutual funds among all U.S. households has expanded significantly since 1980, resulting in funds becoming a household word ...." See 1990 MUTUAL FUND FACT BOOK: INDUSTRY TRENDS AND STATISTICS FOR 1989, at 64 (1990).

<sup>76</sup>1973 Justice Department Comment, *supra* note 47, at 12-15. In addition, the Justice Department noted that Professor Paul Samuelson had testified that elimination of section 22(d) would result in a substantial decrease in sales loads and that these judgments were confirmed by the pre-1940 experience in the mutual fund industry which showed that retail price competition reduced costs to the investor. *Id.* A 1988 ICI-commissioned study suggested that there is a corresponding (and offsetting) increase in market share for a full service channel relative to the direct market channel as the former decreases its commission or fee charges. See ICI, THE DISTRIBUTION CONNECTION: A SUMMARY REPORT OF MAJOR RESEARCH FINDINGS 19 (1990).

<sup>77</sup>1973 Justice Department Comment, *supra* note 47, at 20-23; see also Hearings Before the Sen. Comm. on Banking and Currency, 91st Cong., 1st Sess. 65 (1969) (testimony of Professor Paul Samuelson); Donald Baker & W. Todd Miller, *Vertical Pricing, Territorial and Customer Restraints: The Search for Clarity, or At Least Sanity*, 30TH ANNUAL ADVANCED ANTITRUST SEMINAR, PLI Course Handbook Series No. 720, at 9/55 (1991) (citing SCHERER, INDUSTRIAL MARKET STRUCTURE AND ECONOMIC PERFORMANCE 593 (2d ed. 1980)).

<sup>78</sup>The "free rider" argument resurfaced in the comments to the Study Release, *supra* note 26, with regard to unit investment trusts ("UITs"). See Letter from Davis Polk & Wardwell to Jonathan G. Katz, Secretary, SEC 83 (Oct. 10, 1990), File No. S7-11-90 [hereinafter Davis Polk Study Comment], Letter from Shearson Lehman Brothers to Jonathan G. Katz, Secretary, SEC 21 (Oct. 10, 1990), File No. S7-11-90.

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underwriting expenses often have been subsidized by the investment adviser.<sup>79</sup> Thus, the real benefit of promoting a fund often lies in increasing the asset base of the fund on which the adviser's compensation is determined. The elimination of retail price maintenance would not impair that benefit. Finally, the underwriter's exclusive access to new shares from the fund is a substantial advantage over non-contract dealers, which have the expenses and uncertainties associated with maintaining inventory.<sup>80</sup>

Finally, section 22(d) is not needed to prevent "price discrimination." Competitive markets generally tend to eliminate discriminatory price differences, *i.e.*, differences unrelated to costs. In addition, competition generally should reduce prices for investors at all levels, even though reductions are likely to be most dramatic for the largest investors. The results of the unfixing of brokerage commission rates in 1975 bear these suppositions out; commission rates have declined sharply and fallen into rational patterns that reflect the sales costs and the services provided.<sup>81</sup> Moreover, if, as some have argued, the "investor discrimination" aimed at was not price discrimination, but the discrimination that allowed the favored "insider" purchaser to exploit backward pricing,<sup>82</sup> it became irrelevant in 1968 with the adoption of forward pricing.

## 2. Consequences of Retail Price Competition

In addition to considering whether the original bases for section 22(d) remain valid, we considered other concerns that could arise from retail price competition. In theory, repeal could lead to increased concentration and investor confusion, but we conclude that the benefits would more than offset any disadvantages. Residual rulemaking authority could give the Commission the ability to address any concerns.

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<sup>79</sup>See, e.g., PPI REPORT, *supra* note 11, at 209. Of course, advisory fees and other compensation paid by a fund to its adviser must meet the requirements of section 36(b). See *infra* Section III.A.2.

<sup>80</sup>See 1973 Justice Department Comment, *supra* note 47, at 38-39. See also Davis Polk Study Comment, *supra* note 78, at 81. Non-contract dealers also would reduce the distribution system costs by taking on some of the promotional expenses that encourage investing in the fund as well as taking some of the redemption pressure, and attendant costs, off the underwriter and fund.

<sup>81</sup>See DIRECTORATE OF ECONOMIC POLICY AND ANALYSIS, REPORT ON THE SECURITIES INDUSTRY IN 1980 81-85 (Sept., 1981) [hereinafter 1980 INDUSTRY REPORT].

<sup>82</sup>See Heffernan & Jorden, *supra* note 39, at 994. While this latter view has some support, there are numerous Commission interpretations to the contrary, including some issued after backward pricing was abolished. See, e.g., Sale of Redeemable Securities Without a Sales Load Following Redemption, Investment Company Act Release No. 8235 (Feb. 20, 1974), 39 FR 8321; Variable Annuities, Adoption of Exemptive Rule, Investment Company Act Release No. 8878 (Aug. 7, 1975), 40 FR 33970.

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We do not believe that retail price competition would lead to concentration in the mutual fund and broker-dealer industries, as some have argued. There is no reason to believe that repeal of section 22(d) would cause undue concentration any more than the 1975 unfixing of brokerage commission rates caused undue concentration among broker-dealers.<sup>83</sup> To the extent that some firms might not survive, as a former Commission Chairman stated, "it is hardly necessary or even desirable for the Government to maintain a price structure under which investors -- particularly small investors -- subsidize an inefficient, oversized distribution system . . .".<sup>84</sup>

Nor does it seem likely that the range of commission charges would confuse investors. Negotiation of sales loads theoretically could result in infinite permutations but, as a practical matter, broker-dealers are likely to establish schedules of a limited range of possible loads, just as they currently do for negotiable commission rates on securities purchases for different customers. In essential respects, negotiated sales loads would expand the concept of scheduled variations in rule 22d-1, which is accepted and understood by both the industry and the public.<sup>85</sup>

The current widespread use of rule 12b-1 fees and contingent deferred sales loads<sup>86</sup> will complicate the elimination of retail price maintenance. Unlike front-end sales loads, rule 12b-1 fees do not easily lend themselves to negotiation and secondary markets in fund shares. For example, in the same fund customers

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<sup>83</sup>Although concentration increased in the securities industry between 1971 and 1980, the Directorate of Economic Policy and Analysis concluded that the trend toward concentration began well before the introduction of negotiated rates in 1975, for various reasons, and that despite consolidations, the industry appeared to remain competitive in terms of structure, as well as conduct and performance. See **1980 INDUSTRY REPORT**, *supra* note 81, at 79-80. The staff also noted that the number of discount brokers continued to grow in the period following the full advent of negotiated rates and that their profitability was the highest among the industry segments. See, e.g., *id.* at vi, 85-87.

<sup>84</sup>1967 Senate **Hearings**, *supra* note 32, at 30 (statement of Chairman Cohen). Immediately following the elimination of fixed rates in 1975, commission rates for both individual and institutional clients declined sharply. **1980 INDUSTRY REPORT**, *supra* note 81, at 82.

<sup>85</sup>For example, proposed rule 22d-6 permitting negotiated sales loads had several disclosure conditions designed to assist the investor in evaluating investment costs. The conditions included prospectus disclosure of the maximum load that could be charged, accompanied by a discussion of the circumstances under which a negotiated load was available. See Inv. Co. Act Rel. 13183, *supra* note 38. Similarly, the prospectus fee table used today also includes only the maximum sales load that can be charged and leaves scheduled variations of sales load to be discussed in the narrative. See Consolidated Disclosure of Mutual Fund Expenses, Investment Company Act Release No. 16244 (Feb. 1, 1988), 53 FR 3192.

<sup>86</sup>See *supra* notes 15-18 and accompanying text.

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of non-contract dealers and customers of the principal underwriter and contract dealers would be bearing the same amount of rule 12b-1 fees, despite differences in sales costs.

Second, contingent deferred sales loads, while susceptible to negotiation, would present difficult tracking and inventory questions that are likely to limit the formation of secondary markets. To give an example, assume shareholder A wishes to sell, after two years, shares originally subject to a CDSL of five percent that declined one percent annually until year five when it disappeared. Shareholder A might offer the shares, with a current net asset value of \$10,000, to a dealer, at a price of net asset value minus the CDSL of three percent (or what the fund would redeem them for), *e.g.*,  $\$10,000 - \$300 = \$9,700$ , plus whatever premium the dealer was paying to attract redeeming shareholders, *e.g.*, \$100.<sup>87</sup> The dealer, having paid \$9,800 for shares with a value of \$10,000 minus a declining CDSL of three percent, would hope to sell those same shares to shareholder B, at a discount from what the fund would offer shareholder B (shares at \$10,000 with a contingent liability of five percent or \$500), *e.g.*, \$9,900 or maybe even \$10,200. The spread between the price paid to the selling shareholder and the price paid by the buying shareholder would be the dealer's profit, *e.g.*, \$100 or \$400 in this example.

The market value of the shares depends on how long they have been outstanding (that is, what level the CDSL has reached) and the holding expectations of the buying shareholder. In the example above, the shares would still bear a load of three percent, if redeemed before the end of the third year of the original selling shareholder's purchase. If shareholder B planned to sell the shares quickly, he or she would have an incentive to pay a higher premium to the dealer than a shareholder who planned to hold the shares for two or three years. A shareholder planning to hold shares for the full five years would not pay more than the price at which the fund was offering shares. Dealers, therefore, would have to be able to identify the "aging" of each share in inventory and know their customer.

### 3. Development of Secondary Markets

To the extent that funds seek to restrict secondary market transactions, the Commission could use its existing rulemaking authority under section 22(f). Section 22(f) prohibits funds from restricting the transferability of their shares in

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<sup>87</sup>Securities firms today may act as statutory "brokers," *i.e.*, as agents in a sale of already issued shares between two investors. See, *e.g.*, *United States v. National Ass'n of Sec. Dealers, Inc.*, 422 U.S. 694 (1975). This practice is not common today.

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contravention of any Commission rules.<sup>88</sup> To date, the Commission has not adopted any rules under section 22(f). The Commission's Investment Trust Study detailed a number of problems related to the secondary dealer (or "bootleg") market under the backward pricing system prevalent at the time and listed a variety of means used by funds to deal with those problems, including restricting the negotiability of shares so that they could only be tendered for redemption to the fund and prohibiting the underwriter from taking any trading position in the fund's shares!<sup>89</sup> Commission staff indicated that the provision was designed to provide regulatory "oversight" over these types of practices because of a concern that these practices might also penalize investors.<sup>90</sup>

Leaving section 22(f) intact would reserve authority with the Commission, consistent with the protection of the fund's shareholders, either to preclude certain restrictive practices or to protect contract dealers and underwriters from any unfair advantage on the part of secondary market dealers, should events prove it necessary.<sup>91</sup>

Finally, it may be necessary to amend rule 22c-1 to permit secondary market transactions by dealers at negotiated prices. The rule now requires all dealers to effect transactions at prices based upon the next computation of net

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<sup>88</sup>As the Supreme Court stated in 1975: "[s]ection 22(f) complements [section 22(d)] by authorizing the funds and the SEC to deal more flexibly with other detrimental trading practices by imposing SEC-approved restrictions on transferability and negotiability." *Id.* at 724-25.

<sup>89</sup>INVESTMENT TRUST STUDY, pt. 3, *supra* note 42, at 849,856-57,861,865,867-74. In addition, some funds required their underwriters to impose restrictions on the dealers or entered into restrictive agreements with the dealers directly. *Id.* at 868-71.

%avid Schenker testified that

some companies . . . have a provision in their certificates to the effect that you cannot sell that certificate to anybody else, and the only way you can sell it is to sell it back to the company. That is a technical problem. It presents a whole problem which they call the bootleg market. What happens is that dealers keep switching people from one company to another.

1940 *Senate Hearings*, *supra* note 35, at 292-93. Mr. Schenker went on to state that while the bootleg market was a problem, these restrictions "are taking away a big portion of the owner's right of initiative." His recommendation was that, rather than have an explicit prohibition, the subject "ought to be a matter of rules." *Id.*

<sup>91</sup>For example, a rule under section 22(f) might permit a fund to impose a reasonable fee when ownership of its shares is transferred from a non-contract dealer to a customer to compensate a fund for any administrative costs it incurs.

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asset value.<sup>92</sup> Rule 22c-1 prevents dilution of the shareholders' equity that results from backward pricing. Amending the rule to permit dealers to make secondary markets in fund shares at fully negotiable prices would not be inconsistent with the rule's purpose. The issuance and redemption of shares by funds and their principal underwriters would continue to be based on forward pricing; therefore, secondary market transactions would not lead to dilution or opportunity for riskless trading.

## D. Other Options Considered

### 1. "Voluntary" Retail Price Competition

We considered recommending that the Commission seek expanded authority to permit, but not require, retail price competition. This would permit the Commission to adopt a rule permitting the negotiation of sales loads, similar to proposed rule 22d-6, and also give the Commission flexibility to deal with any new products or any new questions involving secondary market trading of fund shares.

A permissive approach has some appeal. Permitting the voluntary negotiation of sales loads would allow funds to elect price competition to meet market needs, but not force all funds to face those particular competitive pressures immediately. A voluntary approach would allow funds to control the circumstances of their experiments with price competition and might yield some of the benefits of full retail price competition. Under a permissive rule, those funds that believe that retail price maintenance is desirable could continue it.

The obvious flaw with a permissive rule is that only a few funds, if any, likely would "elect" price competition. Historically, dealer pressure on underwriters has increased, not decreased, sales loads. We see no reason to believe that the same pressures would not continue under a voluntary system. Accordingly, we do not recommend this approach.

### 2. The Status Quo

We also considered maintaining the status quo. Opponents of repeal have argued that retail price maintenance has in fact permitted price competition and "worked well" over the last half century, as evidenced by the great variety of sales charges, the increases in the number of no-load funds and low-load funds, and

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<sup>92</sup>The rule has a limited exemption for "backward pricing" by sponsors of unit investment trusts, allowing them conditionally to purchase or sell units in the secondary market at a price based on the offering side, determined weekly.

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the apparent decline of the effective sales charges since 1960.<sup>93</sup> Thus, they conclude that section 22(d) need not be amended.

The Division disagrees. While there is a great degree of interbrand competition in the industry, nonetheless, the statute today precludes intrabrand competition. The original rationales for section 22(d) no longer exist and investors are harmed by higher prices than might otherwise be available in a competitive marketplace.

### **III. Sponsors' Options for Distribution Financing**

Section 22(d) most directly affects funds with front-end sales loads, for a long time the only form of distribution charge paid by investors.<sup>94</sup> Alternative forms of distribution charges, such as rule 12b-1 fees and contingent deferred sales loads, have become increasingly prevalent and have resulted in complex distribution arrangements.

Because these distribution financing techniques are linked, regulation or competition affecting one leads to changes in use of another. Our general recommendation is to continue permitting a variety of distribution charges and regulating all distribution charges in as equivalent a manner as is feasible, and placing renewed emphasis on full and clear disclosure of those charges. Accordingly, the Division generally endorses the NASD's proposed extension of its maximum sales charge rule to asset-based sales charges and CDSLs. The Division also recommends minor amendments to rule 12b-1 to clarify its applicability to spread loads, adoption of proposed rule 6c-10 permitting CDSLs, and adoption of a rule permitting the issuance of multiple classes of shares in the same portfolio.

#### **A. The Treatment of Fees and Distribution Charges under the Act**

Several sections of the Investment Company Act address the use or level of various types of distribution charges. Under section 22(b), the NASD is authorized to prohibit "excessive" sales loads. Section 36(b) imposes a fiduciary duty on investment advisers with respect to fees, including distribution fees, paid

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<sup>93</sup>See, e.g., ICI Study Comment, *supra* note 26, at 50-51. It is difficult, however, to assess whether those rates actually have declined, however, in part because the introduction of rule 12b-1 fees makes comparison difficult, and because the types of funds sold have changed.

<sup>94</sup>Advisers to no-load funds in theory cover any limited distribution expenses out of their own resources.

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by funds to advisers and their affiliates.<sup>95</sup> Section 12(b) authorizes the Commission to make rules governing funds' distribution of their own shares.<sup>96</sup>

## 1. Section 22(b)

In the 1930's, investment company underwriters maintained continuous sales programs to offset redemptions with new sales, with high costs to investors.<sup>8</sup> The costs were due in part to the dependence of underwriters on dealers for sales.<sup>98</sup> This dependence prevented reductions in sales charges<sup>99</sup> and fostered a number of questionable sales practices.<sup>100</sup> In addition, a number of questionable computational techniques resulted in the actual distribution profits being larger than the load itself would have generated.<sup>101</sup>

The Commission addressed these problems in the legislation that it recommended to Congress in 1940.<sup>102</sup> The Commission recommended leaving the level of sales loads to competition among distributors, and retaining jurisdiction to act only where an "unconscionable or grossly excessive sales load" was charged (even if that load were disclosed).<sup>103</sup> Members of the industry expressed a preference for self-policing under the auspices of the NASD.<sup>104</sup> As enacted by Congress in 1940, section 22(b) included a general prohibition on

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<sup>95</sup>15 U.S.C. § 35(b).

<sup>96</sup>15 U.S.C. § 12(b).

<sup>97</sup>INVESTMENT TRUST STUDY, pt. 3, supra note 42, at 807, 809-13, 817, 856.

<sup>98</sup>In a highly competitive field, where most dealers had competing fund shares to sell, "maintenance of dealer good will" was "of paramount importance . . . . [I]n short, any device or practice which would facilitate the task of the dealer might be adopted or encouraged by open-end investment companies in order to assure the continued sale of their securities." *Id.* at 826-27.

<sup>99</sup>*Id.* at 826.

<sup>100</sup>*Id.* at 829-47.

<sup>101</sup>The Commission in the Investment Trust Study observed that "[t]he open-end distribution system permits the inclusion of certain multiple and hidden profits . . . . Thus the various additions and adjustments made in the computation of the selling commission serve to enlarge the distribution profits beyond the apparent implications of the published load." *Id.* at 813.

<sup>102</sup>S. 3580, *supa* note 35, § 22(c).

<sup>103</sup>1940 Senate Hearings, supra note 35, at 290 (testimony of David Schenker).

<sup>104</sup>See, e.g., *id.* at 1057 (testimony of Arthur Bunker, Executive Vice President, Lehman Corp.).

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"unconscionable or grossly excessive sales load[s]," and authorized the NASD to define these terms through rulemaking, subject to Commission review.<sup>105</sup>

By the mid 1960's, the PPI Report documented that the 8.5% front-end sales load then typical for mutual funds reflected large increases in sales charges since the early 1950's, with the increases going to higher dealer concessions.<sup>106</sup> The report observed that profits from advisory fees, and brokerage commissions, as well as a fund's own resources, often subsidized sales efforts.<sup>107</sup>

Although the Commission ultimately recommended a statutory cap of five percent on sales loads in lieu of ending resale price maintenance)<sup>108</sup> Congress decided to rely on the NASD to protect investors against unreasonable sales charges. As part of the 1970 amendments to the Act, section 22(b) was revised to provide for NASD-prescribed sales loads subject to Commission oversight under the Exchange Act.<sup>109</sup> In 1975, the NASD adopted an 8.5% maximum sales load limit, with lower ceilings if certain features were not offered.<sup>110</sup>

## 2. Section 36(b)

Section 36(b) imposes a fiduciary duty on the investment adviser of a registered investment company with respect to fund fees. The duty covers "the receipt of compensation for services, or of payments of a material nature, paid by such registered investment company, or by the security holders thereof, to such investment adviser or any affiliated person thereof." Thus, the adviser's duty

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<sup>105</sup>Investment Company Act of 1940, Pub. L. No. 76-768, § 22(b), 54 Stat. 789, 823 (1940).

<sup>106</sup>PPI REPORT, *supra* note 11, at 204,207-09. In addition, the report noted that the typical fund sales load was between two and a half and five times the "round trip" exchange commission charged for a trade in a listed security, and that loads were charged on reinvested dividends when they were not related to or justified by any special selling effort apart from the initial sale. *Id.* at 209-11, 215-16.

<sup>107</sup>All or part of the cost of preparing prospectuses and sales-oriented shareholder reports were included in fund operating expenses and fund brokerage supplied added cash compensation to dealers selling fund shares. *Id.* at 201.

<sup>108</sup>*Id.*

<sup>109</sup>Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-78ll. Investment Company Act Amendments of 1970, Pub. L. No. 91-547, § 12(a), 84 Stat. 1413,1422 (1970) (codified as amended at 15 U.S.C. § 80a-22(b)).

<sup>110</sup>Proposed Rule Change By the NASD, Investment Company Act Release Nos. 8893 (Aug. 14, 1975), 40 FR 36813 (Notice of Filing and Request for Comment), and 8980 (Oct. 10, 1975), 8 SEC Docket 66 (Order Approving Rule Change).

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under section 36(b) applies not only to advisory fees, but also to distribution charges such as rule 12b-1 payments.<sup>111</sup>

Congress adopted section 36(b) in 1970 in response to concerns articulated in the PPI Report that advisory fees were not subject to usual competitive pressures because of the external management of mutual funds.<sup>112</sup> The PPI Report concluded that the competitive forces that normally restrain prices did not operate efficiently in checking the costs of fund management. The primary reason was that, unlike typical corporations, funds were usually managed and operated by separate entities that provided investment advice and managerial services under contracts with funds. These separate entities usually had their own shareholders and were profit centers in their own right, creating a conflict of interest unique to mutual funds. The virtually complete merger of the funds' management with the advisory organizations meant that funds were not able to "bargain" for advice and the directors' ability to negotiate effectively on behalf of the funds was hampered by their inability, as a practical matter, to fire management in a dispute over fees.<sup>113</sup> In addition, investors did not understand or were not sensitive to the level of advisory fees or to fees generally and, in any case, were not influential because share ownership was so dispersed.<sup>114</sup>

The PPI Report concluded that "mutual fund shareholders need protection against incurring excessive costs in the acquisition and management of their investments and that, given the structure and incentives prevailing in the industry, neither competition nor the few elementary safeguards against conflict of interest deemed sufficient in 1940 . . . presently provide this protection in adequate measure."<sup>115</sup> Accordingly, the report recommended that the Act be amended to require that the compensation received by affiliated persons of investment companies for services furnished to an investment company be reasonable and that this standard be enforceable in the courts.<sup>116</sup>

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<sup>111</sup>See, e.g., *Krinsk v. Fund Asset Management*, 715 F. Supp. 472 (S.D.N.Y.1988), *aff'd*, 875 F.2d 404 (2d Cir.), cert. denied, 110 S. Ct. 281 (1989).

<sup>112</sup>See, e.g., H.R. REP. NO. 1631, 91st Cong., 2d Sess. (1970) (conference report); H.R. REP. NO. 1382, 91st Cong., 2d Sess. 7-8 (1970); id. at 86-88 (*Memorandum of the SEC on H.R. 27333 to the Comm. on Interstate and Foreign Commerce*).

<sup>113</sup>PPI REPORT, *supra* note 11, at 10-12, 126-27, 130-32.

<sup>114</sup>*Id.* at 126, 129-30.

<sup>115</sup>*Id.* at viii.

<sup>116</sup>*Id.* at viii, 143-147.

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Rather than imposing a reasonableness standard, Congress imposed a fiduciary duty on investment advisers with respect to the receipt of compensation for services and instructed a court in any action brought under the provision to give only "appropriate" consideration to any prior approvals of the compensation by shareholders or directors. Congress also amended section 15(c) of the Act<sup>117</sup> to impose on directors a duty to evaluate, and on an adviser a duty to furnish, all relevant information needed to review the terms of advisory contracts. This amendment was designed to strengthen the ability of directors, particularly the independent directors, to carry out their responsibilities with respect to approval of these contracts.<sup>118</sup>

Since the enactment of section 36(b), the relatively few decided cases addressing the issue of management compensation under the Act all have resulted in decisions for fund management.<sup>119</sup> The first of these cases remains the leading authority for evaluating an adviser's breach of fiduciary duty with regard to compensation.<sup>120</sup> One factor identified by that court,<sup>121</sup> the role and decision-making process of fund directors in approving compensation arrangements, has been uniformly considered by following courts as the most important factor in determining section 36(b) liability.<sup>122</sup>

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<sup>117</sup>15 U.S.C. § 80a-15(c).

<sup>118</sup>See S. REP. No. 184, 91st Cong., 1st Sess. 15 (1969).

<sup>119</sup>See *Gartenberg v. Merrill Lynch Asset Management, Inc.*, 528 F. Supp. 1038 (S.D.N.Y. 1981), *aff'd*, 694 F.2d 923 (2d Cir. 1982) ("Gartenberg I"); *Gartenberg v. Merrill Lynch Asset Management, Inc.*, 573 F. Supp. 1293 (S.D.N.Y. 1983), *aff'd*, 740 F.2d 190 (2d Cir. 1984); *Schuyt v. Rowe Price Prime Reserve Fund, Inc.*, 663 F. Supp. 962 (S.D.N.Y.), *aff'd*, 835 F.2d 45 (2d Cir. 1987), *cert. denied*, 485 U.S. 1034 (1988); *Krinsk v. Fund Asset Management*, 715 F. Supp. 472 (S.D.N.Y. 1988), *aff'd*, 875 F.2d 404 (2d Cir.), *cert. denied*, 110 S. Ct. 281 (1989); *Meyer v. Oppenheimer Management Corp.*, 609 F. Supp. 380 (S.D.N.Y. 1984), *rev'd*, 764 F.2d 76 (2d Cir. 1985), *on remand*, 707 F. Supp. 1394 (S.D.N.Y. 1988) (corrected version; originally published at 691 F. Supp. 669) (section 36(b) issue reserved but discussed in dicta), 715 F. Supp. 574 (S.D.N.Y. 1989) (addressing section 36(b) claim), *aff'd*, 895 F.2d 861 (2d Cir. 1990); and *Kalish v. Franklin Advisers, Inc.*, 742 F. Supp. 1222 (S.D.N.Y. 1990), *aff'd*, 928 F.2d 590 (2d Cir.), *cert. denied*, 112 S. Ct. 75 (1991).

<sup>120</sup>*Gartenberg I*, 528 F. Supp. 1038.

<sup>121</sup>The court primarily examined six factors in determining whether a breach of fiduciary duty had occurred. These factors are the nature and quality of the services rendered to the fund; the profitability in providing those services; the economies of scale that may result from fund asset growth and the effect such economies have on the adviser's Compensation; potential fall-out benefits arising from the investment company relationship; fees and expense ratios of other similar funds; and the role and decision-making process of fund directors in approving compensation arrangements. Id.

<sup>122</sup>See, e.g., *Kalish*, 742 F. Supp. at 1241-49; *Schuyt*, 663 F. Supp. at 980-88.

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### **3. Section 12(b)**

Section 12(b) generally provides that a registered open-end investment company may not act as a distributor of its securities, except through an underwriter, in contravention of any rules prescribed by the Commission. The Commission testified in 1940 that this provision was intended to protect investors in open-end companies "against excessive sales, promotion expenses, and so forth."<sup>123</sup> Another explanation of its purpose comes from a commentator writing shortly after the Act's adoption: "[al]l apparently the Commission was particularly fearful of the possibility that open-end investment companies in their formative stages might be made to shoulder the unprofitable burden of selling and distributing their shares during this period of heavy expense and small return, building up the investment company for the benefit of some controlling person."<sup>124</sup> Thus, section 12(b) was intended to prevent abuses through the grant to the Commission of authority to regulate the use of fund assets to pay for distribution.<sup>125</sup>

## **B. Administrative Action Since 1940**

### **1. The Use of Fund Assets to Pay for Distribution**

The Commission did not exercise its authority under section 12(b) to prescribe a rule governing the use of fund assets for distribution until 1980, when it adopted rule 12b-1.<sup>126</sup> Since the adoption of the rule, more than half of all mutual funds have enacted rule 12b-1 plans, using these charges, alone or with sales loads, as the primary means of financing distribution.<sup>127</sup> Other funds, typically funds with no front-end loads, have added a relatively modest rule 12b-1 fee to pay for some sales commissions, printing prospectuses and sales literature, advertising, and similar expenses.

When the Act was adopted, most funds charged a front-end sales load. By the mid-1970's, the no-load segment of the industry had increased

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<sup>123</sup>1940 House Hearings, *supra* note 37, at 112 (statement of David Schenker).

<sup>124</sup>Alfred Jaretzki, Jr., *The Investment Company Act of 1940*, 26 WASH. U. L. Q. 303,324-25 (1941).

<sup>125</sup>See also Inv. Co. Act Rel. 11414, *supra* note 15, at n.49 and accompanying text (adopting rule 12b-1).

<sup>126</sup>The legislative and administrative history leading up to the adoption of rule 12b-1 is lengthy. It is recounted in detail in Inv. Co. Act Rel. 16431, *supra* note 16.

<sup>127</sup>See Lipper Directors' Analytical Data Vol. I, Sec. III, at 3, Vol. II, Sec. II, at 157 (1st ed. 1992).

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significantly.<sup>128</sup> The distribution expenses of these no-load funds were borne by their investment advisers. As the popularity and number of no-load funds increased, several of these funds requested that the staff take a no-action position allowing them to use fund assets to pay for distribution. These requests were generally denied in accordance with the traditional position of the Commission that the use of fund assets to pay the costs of distributing fund shares was improper.<sup>129</sup>

The industry nonetheless continued to press its view, pointing to the increase in net redemptions in some segments of the fund industry, the growing resistance to high front-end sales loads, and the rising popularity of no-load funds.<sup>130</sup> It argued that the rigidity of the regulatory approach for fund distribution put mutual funds at a disadvantage to competing investment products that could be offered to investors without such sales loads.<sup>131</sup> The industry also argued that use of fund assets for distribution expenditures would result in a net flow of cash into funds, and in turn, economies of scale and more effective portfolio management.<sup>132</sup>

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<sup>128</sup>See 1974 DISTRIBUTION REPORT, *supra* note 14, at 19, 20-22.

<sup>129</sup>See, e.g., Axe-Houghton Funds (pub. avail. Nov. 15, 1973). See also Inv. Co. Act Rel. 9470, *supra* note 61, at n.1 and accompanying text. Despite the traditional position, investment companies were allowed on a number of occasions to bear distribution expenses under circumstances which served to lessen the potential for overreaching. First, certain funds that had internalized management functions were allowed to pay distribution expenses out of fund assets. See, e.g., Broad Street Investing Corp., Investment Company Act Release Nos. 7071 and 7072 (Mar. 16, 1972), 37 FR 5846 (Notices of Applications) and 7114 and 7117 (Apr. 14, 1972)(Orders); see generally PPI REPORT, *supra* note 11, at 49. Nor did the Commission object generally to the payment of fund distribution expenses by the fund's investment adviser; where, however, the advisory fee was increased in contemplation of payments for distribution by the adviser, the staff took the position that the advisory fee might result in a violation of section 36(b). See Inv. Co. Act Rel. 16431, *supra* note 16, at nn.11-13 and accompanying text. Historically, the Commission's opposition was based on the potential conflict inherent in the fact that, given the external management of mutual funds, most decisions relating to the use of fund assets are made by a fund's adviser, which directly benefits from increased sales of fund shares because its compensation is based on a percentage of fund assets. The Commission also was concerned whether using fund assets for distribution would in fact benefit existing shareholders. See Inv. Co. Act Rel. 9470, *supra*.

<sup>130</sup>Hearings on the Bearing of Distribution Expenses by Mutual Funds, File No. 4-186, Tr. at 23, 248-49, 307-08. Inv. Co. Act Rel. 16431, *supra* note 16, at text following n.13.

<sup>131</sup>See Bearing of Distribution Expenses by Mutual Funds, Investment Company Act Release No. 10252, text accompanying nn. 2-3 (May 23, 1978), 43 FR 23589 (advance notice of proposed rulemaking).

<sup>132</sup>See *id.*

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In 1979, after extensive consideration,<sup>133</sup> the Commission proposed rule 12b-1, stating that funds should be permitted to bear distribution expenses if they were disclosed and regulated.<sup>134</sup> The Commission adopted rule 12b-1 in October 1980.<sup>135</sup>

## 2. Contingent Deferred Sales Loads

The use of CDSLs developed contemporaneously with the use of rule 12b-1 plans and indeed worked in tandem with them since the load is imposed to assure recoupment to the distributor of the costs of distribution. Where a fund might once have charged a six percent front-end load, it might now roughly recoup **the** same six percent through a combination of rule 12b-1 fees and contingent deferred loads.<sup>136</sup> This "spread load" arrangement grew in popularity during the 1980's as many retail broker-dealers advanced to their salespersons large amounts of commissions for mutual fund sales, expecting reimbursement from future rule 12b-1 fees and CDSLs.<sup>137</sup>

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<sup>133</sup>In late 1976, the Commission held public hearings on the appropriateness of open-end companies bearing expenses related to the distribution of their shares. In 1977, the Commission considered that proposal but later issued a release stating it was still considering the question. Bearing of Distribution Expenses by Mutual Funds, Investment Company Act Release No. 9915 (Aug. 31, 1977), 42 FR 44810. In 1978, the Commission issued an advance notice of proposed rulemaking stating that the Commission had not decided whether funds could benefit from paying distribution expenses. Inv. Co. Act Rel. 10252, *supra* note 131, at text accompanying n.4 and text following n.9.

<sup>134</sup>See Bearing of Distribution Expenses by Mutual Funds, Investment Company Act Release No. 10862 (Sept. 7, 1979), 44 FR 54014 (proposing rule 12b-1).

<sup>135</sup>Inv. Co. Act Rel. 11414, *supra* note 15.

<sup>136</sup>See, e.g., Drexel Burnham Fund and DBL Tax-Free Fund, Inc., Investment Company Act Release Nos. 16201 (Jan. 22, 1988), 53 FR 2664 (Notice of Application), and 16284 (Feb. 24, 1988), 40 SEC Docket 548 (Order). The Commission's 1988 release proposing rule 6c-10, an exemptive rule permitting funds to impose deferred sales loads (including contingent loads), discusses the legislative and administrative history of these arrangements in detail. Inv. Co. Act. Rel. 16619, *supra* note 20.

<sup>137</sup>For example, one fund that pioneered the use of a spread load grew from about \$109 thousand to almost \$4 billion in assets in a single year. During that year, the distributor spent roughly \$205 million on behalf of the fund and received only \$23 million in rule 12b-1 fees and \$3 million in CDSLs, resulting in unreimbursed distribution fees of over \$179 million. Assuming constant asset size and no redemptions, it would have taken five years to recover this "carryover" amount. Although the distributor treated the carryover as an asset – a receivable to be collected in future years – the fund did not consider the carryover to be a liability. Rather, the fund recognized only a current expense in an amount equal to the amount of rule 12b-1 fees paid that year (\$23 million) because it was not contractually obligated to pay any additional amounts if the  
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The spread load is essentially a financing of a front-end sales load. Unfortunately, neither component of the spread load is as obvious to investors as is a front-end sales load. The rule 12b-1 charge is deducted as an expense at the fund level, while the CDSL is deducted out of an individual shareholder's redemption proceeds.

### 3. The Commission's 1988 Proposals to Limit Spread Loads and Permit Installment Loads

In 1988, the Commission proposed broad amendments to rule 12b-1.<sup>138</sup> The proposal reflected concern with the open-ended nature of distribution payments and their criticism by some as "hidden loads." The proposal would have effectively prohibited the use of spread loads as alternatives to front-end loads.

Shortly thereafter, the Commission proposed rule 6c-10, in part to codify exemptive orders issued to applicants permitting CDSLs.<sup>139</sup> Proposed rule 6c-10 went beyond these orders to allow non-contingent deferred sales loads, including installment loads.<sup>140</sup> Proposed rule 6c-10 was intended to provide greater flexibility to mutual funds in their distribution arrangements, especially

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<sup>137</sup>(..continued)

rule 12b-1 plan was cancelled or allowed to lapse by the board of directors. Of the \$205 million spent by the distributor, 45% represented commission credits to brokers and 52% represented an allocation of branch office overhead, sales seminar costs, travel expenses of mutual fund sales coordinators, and other incidental expenses related to branch sales promotion. Prudential-Bache Government Plus Fund, Inc., Prospectus 11-13 (May 1, 1986) and Statement of Additional Information B-15 to B-17, B-25 to E28 (May 1, 1986), SEC File No. 2-82976.

<sup>138</sup>See Inv. Co. Act Rel. 16431, *supra* note 16.

<sup>139</sup>Inv. Co. Act Rel. 16619, *supra* note 20.

<sup>140</sup>Commission rules relating to certain variable life insurance contracts permit sales loads to be deducted over time, as well as upon redemption. See rule 6e-3(T) under the Investment Company Act, 17 C.F.R. § 270.6e-3(T). See also Separate Accounts Funding Scheduled Premium Variable Life Insurance Contracts, Investment Company Act Release No. 14421 (Mar. 15, 1985), 50 FR 11709 (proposing amendments to Rule 6e-2 that would, among other things, permit installment loads and loads on redemption for scheduled contracts). In addition, the Commission has issued exemptive orders to permit sales loads to be deducted from variable annuity contract owner accounts over time. See, e.g., MB Variable Life Ins. Co., et. al., Investment Company Act Release Nos. 18434 (Dec. 10, 1991), 56 FR 65528 (Notice of Application), and 18476 (Jan. 8, 1992), 50 SEC Docket 1145 (Order).

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arrangements designed to offer shareholders deferred payments for sales charges without use of rule 12b-1 plans.<sup>141</sup>

Both proposals were met by a storm of criticism from the industry, which regarded them as dooming spread loads without a satisfactory replacement, forcing most spread load funds to revert to front-end loads.<sup>142</sup> They rejected installment loads as a feasible alternative to spread loads.<sup>143</sup> They predicted that investors would reject funds in favor of other investments that permitted deferred charges, *e.g.*, variable annuities.<sup>144</sup> Critics also argued that the proposals would jeopardize maintenance of viable distribution systems. Such systems, they argued, stimulate growth and benefit funds and shareholders by enabling advisers to build stronger advisory organizations, with greater economies of scale and more sophisticated communication and data processing facilities for shareholder servicing.<sup>145</sup> Many of these commenters contended that funds would not be interested in using non-contingent deferred sales loads because of high administrative costs and operational difficulties.<sup>146</sup>

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<sup>141</sup>Inv. Co. Act Rel. 16431, *supra* note 16, at n.84; Inv. Co. Act Rel. 16619, *supra* note 20, at text following n.33.

<sup>142</sup>See, *e.g.*, Letter from Keystone Group, Inc. to Jonathan G. Katz, Secretary, SEC 1 (Jan. 6, 1989), File No. S7-24-88 (responding to Inv. Co. Act Rel. 16619, *supra* note 20); ICI Rule 12b-1 Comment, *supra* note 16, at 4. They noted that spread load plans had been adopted by more than 300 funds with over seven million shareholder accounts and assets exceeding \$70 billion. With respect to the rule 12b-1 amendments, the Commission received 91 letters from the industry, 1,650 letters from individual investors, and over 70 congressional inquiries regarding the proposing release. Generally, individual investors supported the amendments.

<sup>143</sup>See, *e.g.*, Letter from the ICI to Jonathan G. Katz, Secretary, SEC 13-16 (Jan. 9, 1989), File No. 57-24-88 (responding to Inv. Co. Act Rel. 16619, *supra* note 20) [hereinafter ICI Rule 6c-10 Comment]; Letter from the Subcomm. on Investment Companies and Investment Advisers of the Comm. on Federal Regulation of Securities, Section of Corporation, Banking and Business Law, American Bar Association, to Jonathan G. Katz, Secretary, SEC 3 (Jan. 31, 1989), File No. S7-24-88 (responding to Inv. Co. Act Rel. 16619, *supra* note 20).

<sup>144</sup>ICI Rule 12b-1 Comment, *supra* note 16, at 11.

<sup>145</sup>For example, the ICI also contended that the practical effect would be to prevent new and smaller funds from adopting or continuing spread loads while permitting large, established funds with a large asset base to finance new shares on the proposed current or one year basis. In addition, the ICI argued that the amendments would frustrate the legitimate expectations of underwriters and investors. ICI Rule 6c-10 Comment, *supra* note 143, at 15; ICI Rule 12b-1 Comment, *supra* note 16, at 5-6.

<sup>146</sup>See, *e.g.*, ICI Rule 6c-10 Comment, *supra* note 143, at 2-3. Cf. Letter from IDS Financial Corp. to Jonathan G. Katz, Secretary, SEC 1 (Jan. 3, 1989), File No. 57-24-88 (responding to Inv. Co. Act Rel. 16619, *supra* note 20).

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Some critics also argued that the proposed prohibition on the use of the no-load label by all funds with rule 12b-1 plans did not distinguish between funds that are essentially no-load but assess a small charge to pay for supplemental distribution expenses and those that use rule 12b-1 plans as the functional equivalent of front-end sales loads.<sup>147</sup>

### C. Proposed NASD Regulation of Rule 12b-1 Fees

In response to the 1988 proposal, the NASD sought to address the concern that rule 12b-1 fees were being used to circumvent the NASD imposed limitations on excessive sales loads<sup>148</sup>. Subsequently, it proposed amendments to its maximum sales load rule.<sup>149</sup> The amendments would limit all sales charges, including front-end loads, rule 12b-1 payments, and CDSLs.<sup>150</sup>

The NASDs espoused objective was to assure in the simplest and most expedient way that shareholders paying for distribution indirectly through rule

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<sup>147</sup>See, e.g., ICI Rule 12b-1 Comment, *supra* note 16, at 71-72; Letter from ICI to Jonathan G. Katz, Secretary, SEC 3-4 (May 10, 1991), File No. SR-NASD-90-69 (responding to Exch. Act Rel. 29070, *supra* note 18) [hereinafter ICI NASD Rule Comment].

<sup>148</sup>Form 19b-4, Proposed Rule Change by NASD 10-11(Dec. 28, 1990), File No. SR-NASD-90-69 [hereinafter NASD Proposal].

<sup>149</sup>The NASD extensively regulates sales compensation paid in connection with sales of securities by its members under Article III, Section 1 of the Rules of Fair Practice. NASD Manual (CCH) ¶ 2151. See also NASD Proposal, *supra* note 148, Exhibit 5. See NASD Notice to Members No. 90-26 (Apr. 1990) and NASD Notice to Members No. 90-56 (Sept. 1990). In response to the Study Release (*supra* note 26), several commenters supported NASD regulation as a more acceptable alternative than the 1988 Commission proposal. See, e.g., ICI Study Comment, *supra* note 26, at 52-53.

<sup>150</sup>In brief, the NASD proposal would create a rolling cap of 6.25% of new gross sales, plus annual interest equal to the prime rate plus one percent on the total sales charges -- front-end, asset-based, and deferred -- for funds that pay "service fees" and a rolling cap of 7.25% for funds that do not pay service fees. The reduction from 8.5%, the maximum permitted sales charge under the present rule governing front-end loads occurs because asset-based sales charges do not provide quantity discounts or rights of accumulation. New gross sales are defined to exclude the reinvestment of distributions and complex-wide exchanges of shares. Service fees are defined under the proposal as payments by a fund for personal service and/or shareholder account maintenance. The rule also imposes an annual cap on the amount of asset-based sales charges that may be collected in any one year of .75% of average annual net assets. In addition, a maximum .25 of 1% of its average annual net assets may be paid by a fund for personal service and/or account maintenance of shareholder accounts as a "service" fee, which is not counted in the .75% cap. If the maximum aggregate cap is reduced to zero, no more rule 12b-1 fees may be collected until there are new sales; if the fund continues to receive deferred charges on redemption, those monies may not be used to pay for sales-related expenses. See NASD Proposal, *supra* note 148, at 2-9.

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12b-1 fees would pay no more than those paying at the front-end<sup>151</sup>. The present state of technology forced it to reject tagging rule 12b-1 fees to individual accounts. It opted, therefore, for fund-level accounting, which could be implemented rapidly and would not preclude the industry from eventually implementing individual shareholder accounting.<sup>152</sup> Accordingly, the NASD proposal requires fund-level accounting as the minimum standard. It preserves the use of spread loads.<sup>153</sup>

#### **D. Limited Amendments to Rule 12b-1**

In light of the NASD's proposal to limit asset-based sales charges, we recommend that the Commission adopt only limited changes to rule 12b-1, not the broader amendments proposed in 1988. The Division's recommendation would permit the continued use of spread loads.

Those opposing the 1988 rule proposal generally have argued that the present variety of fees and charges provides fund sponsors with needed pricing flexibility and gives investors a wide range of payment options.<sup>154</sup> For example, the ICI believes that improved required disclosures, such as the prospectus fee table<sup>155</sup> and disclosure of the existence of CDSLs on the front of confirmations,<sup>156</sup> will reduce investor confusion about the multiplicity of sales load structures.<sup>157</sup> The ICI also argues that the Commission's concerns about the level of rule 12b-1 fees are most effectively addressed by direct NASD regulation.<sup>158</sup>

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<sup>151</sup>*Id.* at 10-11 and 17-19.

<sup>152</sup>See Exch. Act Rel. 29070, *supra* note 18 at II.C. Fund-level accounting requires that all sales charges end when a percentage of gross sales is reached while individual shareholder accounting requires separate tabulation of all charges paid by each shareholder. *Id.*

<sup>153</sup>In addition to addressing rule 12b-1 fees, the current rule would be modified to include explicitly deferred sales charges.

<sup>154</sup>See ICI Study Comment, *supra* note 26, at 51-53.

<sup>155</sup>See *infra* notes 181 and 200 and accompanying text.

<sup>156</sup>Order Granting Approval to Proposed Rule Change Relating to Disclosure of Deferred Sales Charges, Exchange Act Release No. 29069 (Apr. 11, 1991), 56 FR 15654.

<sup>157</sup>See ICI Study Comment, *supra* note 26, at 53; ICI Rule 12b-1 Comment, *supra* note 16, at 17-18.

<sup>158</sup>See ICI NASD Rule Comment, *supra* note 147, at 1-2.

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While the NASD proposal would not entirely resolve the problems that gave rise to the 1988 proposals, it is a step in the direction of limiting fee levels. In addition, while reverting to the status quo ante may have some appeal to those who yearn for a simpler time, the fact is that many investors may wish to finance their sales loads through a spread load arrangement and would not appreciate elimination of that option.

We remain concerned, however, that the inherent lack of transparency of spread loads compromises competitive pressures on fee levels. Although the methods for calculating shareholder transaction expenses and fund operating expenses are disclosed in the prospectus, comprehensible disclosure of spread loads, and what amount an individual ultimately will pay, is inherently difficult. The rule 12b-1 fee component of this type of sales load is deducted at the fund level as an expense of the fund, before the calculation of net asset value and investment return, and not as a dollar amount periodically deducted from a shareholder's account as an installment load would be. In the prospectus, it is listed with the other fund operating expenses, such as management and other fees, and not with the shareholder transaction expenses which include the other types of sales loads. The CDSL component of the spread load is even less visible or convertible to a "sum certain" at the time the investment is made.<sup>159</sup>

To address the disclosure problem, we considered recommending that all funds be required to pay for transaction-based distribution charges (largely sales commissions) out of individual shareholder sales loads, which could be either the front-end or the installment type, rather than out of fund assets. All other types of distribution expenses could be paid for by the adviser, out of its management fee.

While this approach has considerable appeal, we concluded that tax law complications<sup>160</sup> would make the method essentially impossible. Unless and until the tax laws change, we think spread loads generally should be permitted. Thus, at least at present, the Division recommends that the Commission adopt **only** the portions of the proposed amendments to rule 12b-1 that are consistent with the use of spread loads.

The Division, however, remains concerned with investor understanding of rule 12b-1 fees and will continue to focus on improving disclosure of these

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<sup>159</sup>The accounting treatment of spread loads exacerbates the confusion. When a principal underwriter advances commissions to salespersons, it records as an asset on its books a receivable from the fund, but the fund does not report a matching liability on its books. In economic reality, however, the fund probably will be paying for much of the sales commission over the next several years.

<sup>160</sup>See *infra* text accompanying notes 165-68.

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arrangements. The recent NASD rule amendment to require disclosure of the existence of contingent deferred sales loads on confirmations is a positive step. In addition, we believe investor demand may cause more funds to adopt methods of financing distribution other than spread loads, such as multiple class arrangements with a "conversion" feature,<sup>161</sup> and low front-end sales loads.<sup>162</sup> We believe, too, that the unified fee investment company proposal that we discuss below also will be used by funds to meet investor demand for simple and more easily understandable fee arrangements.

### E. Adoption of Rule 6c-10

The Division recommends that the Commission adopt rule 6c-10 largely as proposed to provide for both CDSLs and non-contingent deferred loads such as installment loads. Commenters supported adoption of proposed rule 6c-10 to the extent it would have codified exemptive orders for CDSLs.<sup>163</sup> By and large, they roundly criticized the proposal for non-contingent loads, however, as operationally infeasible because of high administrative costs and operational difficulties associated with the implementation of such charges, adverse tax consequences for shareholders, and aspects that would make the loads economically undesirable for underwriters.<sup>164</sup>

The Division disagrees with that criticism. The funds that currently impose a contingent load or offer class conversions may well possess the type of operational systems and procedures necessary to offer the non-contingent deferred loads that would be permitted under the rule. In addition, whether the implementation of a deferred load would result in substantial costs or difficulties will depend on many factors, including the complexity of the load. In any case,

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<sup>161</sup>See, e.g., *infra* note 174 and accompanying text.

<sup>162</sup>For example, the Lexington family of funds recently changed from front-end loads to a no-load structure. See Lexington Goes No-load, DONOGHUE'S MONEYLETTER 7 (Oct. 1990).

<sup>163</sup>Thirty-eight commenters responded; seven commented only on the life insurance separate account rules. Almost all supported codification of CDSL exemptive orders. See, e.g., ICI Rule 6c-10 Comment, *supra* note 143, at 2-3.

<sup>164</sup>Eight commenters opposed non-contingent deferred sales loads. See Letter from the American Bar Association, Section of Business Law, to Jonathan G. Katz, Secretary, SEC 4 (Jan. 31, 1989), File No. S7-24-88; Letter from the ICI to Jonathan G. Katz, Secretary, SEC 2-3, 6, 8-11 (Jan. 9, 1989), File No. S7-24-88; Letter from IDS Financial Co., to Jonathan G. Katz, Secretary, SEC 1-2 (Jan. 3, 1989), File No. S7-24-88; Letter from Keystone Group to Jonathan G. Katz, Secretary SEC 1 (Jan. 6, 1989), File No. S7-24-88; Letter from the NASD to Jonathan G. Katz, Secretary, SEC 1 (Mar. 14, 1989), File No. S7-24-88; Letter from NYLIFE Securities to Jonathan G. Katz, Secretary, SEC 2-4 (Dec. 30, 1988), File No. S7-11-88; and two individual investors. Sixteen commenters supported non-contingent deferred sales loads; of those, fifteen were individual investors.

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technology is evolving rapidly and it is reasonable to anticipate that cost-effective systems for implementing even the most complex types of loads will be available soon, if they are not already.

We also note that the rule offers a voluntary option. A fund not able to take advantage of its provisions would not be required to do so.

We recognize that the tax laws are a significant impediment to implementing non-contingent deferred loads and installment loads. The tax laws may prohibit payments of installment loads in certain **tax-privileged** situations, such as Individual Retirement Accounts or pension accounts.<sup>165</sup> In addition, the collection of installment loads is likely to occur through redemptions of fund shares,<sup>166</sup> which is a taxable event. Investors either would incur **tax** liabilities for gains when not actually receiving any distributions or would realize losses.<sup>167</sup> Investors also would bear added recordkeeping burdens, because each installment of a deferred load would be treated as an increase in the shareholder's basis.<sup>168</sup>

On balance, we conclude the benefits of proposed rule 6c-10, a permissive rule, outweigh the problems raised by commenters. In addition to codifying orders permitting CDSLs, the proposed rule would allow noncontingent deferred loads, which some funds may choose to implement. Indeed, the Division proposed the rule only after receiving informal inquiries whether such loads could be imposed on fund shares. Accordingly, the Division recommends that rule 6c-10 be adopted, largely as proposed, but with certain modifications suggested by commenters to improve the mechanics of the rule. We recognize, however, that installment loads likely will not be used without tax reform.

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<sup>165</sup>Payments from pension plans and individual retirement accounts and annuities that are not considered rollovers would likely be taxed to the investor as a distribution. See Internal Revenue Code of 1986, 26 U.S.C. §§ 402(a)(5) and 408(d)(3). For an IRA, the entire account may lose its exempt status and the investor would recognize the amount of that distribution in taxable income for that tax year. See Internal Revenue Code of 1986, 26 U.S.C. §§ 4975(e)(2)(A), (B), 408(e)(2), 402(a)(1) and 408(d)(1).

<sup>166</sup>Alternatively, the installment load could be billed directly to the customer (with no adverse tax consequences in most cases) or deducted from the shareholder's dividends; or the customer's shares, if any, in a related money market fund could be redeemed to cover the charges. The tax consequences for shareholders of an annual installment payment would be similar to those of an annual redemption elected by a shareholder for trading or other purposes.

<sup>167</sup>In addition to shareholder recognition problems, tax-related issues involve imputed interest (and investment interest expense) and withholding; other difficult issues raised by deferred loads would include access to margin securities and receivables at the distributor level.

<sup>168</sup>Bills introduced in the 102nd Congress would require funds to provide shareholders and the Internal Revenue Service with cost basis information for all fund shares redeemed, taking into account all adjustments to basis, *e.g.*, returns of capital, wash sales. See, *e.g.*, H.R. 2735 and S. 530, 102nd Cong., 1st Sess. (1991).

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## F. Multiple Class Exemptive Rule

Since 1985, a number of funds have obtained exemptive orders permitting them to issue multiple classes of securities, with each class subject to a different distribution arrangement, but representing interests in the same portfolio of investments.<sup>169</sup> Typically, the classes are identical in all respects except for the allocation of distribution, administrative, or support service expenses, and related incremental expenses (*i.e.*, transfer agency fees), differences in voting rights, and dividend payment differences. The funds fall into three basic types, which roughly may be characterized as "multiclass" funds, "dual distribution" funds, and "conversion" funds, although more recent orders have mixed some of the features of these types.<sup>170</sup>

"Multiclass" funds were the first type used. They were created to compete for the short-term investments of certain institutional investors. The investors wanted services adapted to their particular needs. Typically, multiclass funds enter into arrangements whereby particular classes of fund shares are sold to specific institutional investors, such as banks acting in a fiduciary, advisory, agency, custodial, or similar capacity on behalf of customer accounts, insurance companies, investment counselors, brokers, or other financial institutions.<sup>171</sup> In some cases, one or more of the classes are sold directly to individuals.<sup>172</sup> The fund usually makes payments to the institution for providing administrative or shareholder services and, sometimes, for distribution services as well. This arrangement allows the "unbundling" of services typically provided by the fund and permits institutional investors to select the services they wish to provide to their shareholders.

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<sup>169</sup>The applicants received exemptive orders under section 6(c) (15 U.S.C. § 80a-6(c)) from section 18 (15 U.S.C. § 80a-18) to the extent that the arrangements might be deemed to result in the issuance of a "senior security" and to be inconsistent with the requirement that every share have equal voting rights. See releases cited *infra* notes 171-74.

<sup>170</sup>A recent related development is the "hub and spoke" fund structure, under which funds with different costs share a single investment portfolio. It is similar to a multiclass structure, but uses separate funds instead of classes. Typically, the spoke funds invest solely in the hub fund, which holds the investment portfolio and bears advisory fees.

<sup>171</sup>See, e.g., The Hex-Funds, Investment Company Act Release Nos. 18110 (Apr. 23, 1991), 56 FR 19888 (Notice of Application) and 18162 (May 21, 1991), 48 SEC Docket 1685 (Order); Federated Securities Corp., Investment Company Act Release Nos. 17645 (Aug. 2, 1990), 55 FR 32531 (Notice of Application), and 17715 (Aug. 30, 1990), 46 SEC Docket 1993 (Order) (permitting unlimited number of future classes and allocation of a broad array of expenses by class).

<sup>172</sup>See, e.g., Mutual Fund Group, Investment Company Act Release Nos. 17539 (June 19, 1990), 55 FR 26045 (Notice of Application), and 17590 (July 17, 1990), 46 SEC Docket 1366 (Order).

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"Dual distribution" funds typically have two classes that bear different distribution charges, *e.g.*, a front-end load and a spread load. They have a somewhat different purpose -- to allow investors to select the method of financing distribution best suited to their investment horizon and the size of their investment. For example, investors who would qualify for a significant reduction in the front-end load or investors who will be holding their shares for a long time may decide that a front-end sales load is preferable to an ongoing distribution fee under a spread load.<sup>173</sup>

The "conversion" funds are a variant of the dual distribution funds. Typically, investors may still choose between two classes, one with a front-end load and no or a relatively low rule 12b-1 fee, and the other with a spread load, but with a relatively large rule 12b-1 fee. Shares of the spread load class convert to shares of the other class, without payment of any fee or load, after a specified period (*e.g.*, four to eight years) designed to permit the principal underwriter to recover its distribution expenses.<sup>174</sup> The conversion feature limits the rule 12b-1 plan payments borne by each shareholder to an amount approximately equal to the distribution expenses incurred on the shareholder's behalf in the primary distribution while also placing a ceiling on the compensation received by the distributor for these initial distribution expenses.

The conditions to exemptive orders have addressed three areas of concern. The first is possible conflicts of interest among the classes of shareholders, especially as to the allocation of expenses. To address this concern, the applicants have agreed that the funds' directors will monitor for material conflicts and take action necessary to remedy such conflicts. In addition, the funds' methodology for allocating direct and indirect distribution expenses among the classes is reviewed by an outside expert and approved by the independent directors.

The second area addressed is the funds' calculation of different net asset values. The net asset values of the classes in some types of funds usually will vary. For example, a front-end load class having lower expenses than a spread load class, which bears the rule 12b-1 plan expenses and the related higher transfer agency costs, will be entitled to receive more of the fund's current net

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<sup>173</sup>See, *e.g.*, Merrill Lynch California Municipal Series Trust, Investment Company Act Release Nos. 16503 (July 28, 1988), 53 FR 29294 (Notice of Application), and 16535 (Aug. 23, 1988), 41 SEC Docket 1165 (Order) (first dual distribution order) [hereinafter Merrill Order], amended in Merrill Lynch Short-Term Global Income Fund, Inc., Investment Company Act Release Nos. 18015 (Feb. 22, 1991), 56 FR 8814 (Notice of Application), and 18059 (Mar. 22, 1991), 48 SEC Docket 838 (Order).

<sup>174</sup>See, *e.g.*, Alliance Short-Term Multi-Market Trust, Inc., Investment Company Act Release Nos. 17295 (Jan. 8, 1990), 54 FR 1300 (Notice of Application), and 17330 (Feb. 2, 1990), 45 SEC Docket 1024 (Order).

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assets on a per share basis. Applicants have retained an outside expert to assure that the funds have systems to compute net asset values accurately.

The third area addressed is whether investors receive information enabling them to understand a multiple class arrangement and make informed investment decisions. Certain disclosures have been required, *e.g.*, that salespersons' compensation depends upon which class is sold and differences in the yields and total returns for the respective classes.

The Division recommends that the Commission adopt a rule permitting funds to issue multiple classes of shares in a single underlying portfolio. We intend to re-examine the conditions imposed on applicants, with a view towards streamlining them. A more general rule would simplify the procedure for creating multiple classes, saving time and reducing expenses. Multiple class funds are a useful structure that can increase investor choice, result in economies of scale and certain efficiencies in the distribution of fund shares, and allow fund sponsors to tailor products more closely to the needs of investors.

#### **IV. The Unified Fee Investment Company: An Alternative**

As the foregoing discussion suggests, mutual fund fee structures have grown increasingly complicated in the last two decades. The array of fees and loads now available to investors does increase investor choice, but may also impede price competition. The Division believes that price competition might be improved if, ironically, still *another* form of investment company were permitted -- one with a simplified fee structure and low barriers to exit by dissatisfied shareholders.

Accordingly, the Division recommends that the Commission propose legislation to permit the introduction of a new investment vehicle, which we term a unified fee investment company ("UFIC"). The UFIC would have a single, fixed fee set by the vehicle's "investment manager" and no separate sales charges or redemption fees. All UFIC expenses, except brokerage commissions on the fund's own portfolio transactions and extraordinary costs, would be paid from the single fee or from the manager's own resources. Rule 12b-1 would not apply. The level of the fee would be prominently displayed on the cover page of the prospectus and in all sales literature and advertising. To protect investors should competition not restrain fee levels for the UFIC, the Act would prohibit "unconscionable or grossly excessive" unified fees.

The UFIC would have a board of directors to police operational conflicts and approve a variety of operational activities, just as do other funds. The UFIC's board also would be charged with approving the investment manager's contract with the fund, and ensuring that the level of the single fee is not unconscionable

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or grossly excessive. Short of protecting shareholders against such fees, however, the board would not be responsible for negotiating the level of the fee, nor would the board be required to scrutinize the fee provisions of the fund's investment advisory contracts. The board also would oversee the level of services provided to the UFIC through review of all material service contracts. Shareholders would elect directors in accord with section 16(a) of the Act. Two-thirds of the directors would be independent; and, once initially selected by the UFIC sponsor, the independent directors would be self-nominating.

The UFIC's shareholders would not vote on issues related to fees or contracts. Thus, they would not vote to approve or terminate the management contract, any investment advisory contract, or any other contracts for fund services. Their authorization would not be needed to increase the rate of the unified fee. Rather, after reviewing advance notice of a fee increase or contractual change, shareholders would have the opportunity to accept or reject the increase or change by remaining in the fund or redeeming their shares. The shareholders would have all other voting rights mandated for shareholders of open-end companies.

The UFIC's single fee would be reflected in the vehicle's performance figures and could be readily compared with the fees charged by other UFICs. Without sales loads as barriers to exit, dissatisfied UFIC investors could redeem freely. This ready ability to exit should focus managers on keeping expense levels low and investors satisfied.

Regulatory provisions imposed by the 1970 amendments to the Investment Company Act to counteract the ineffectiveness of competitive forces on fee levels would not apply to the UFIC. Thus, section 36(b) would not apply to the fee paid to the UFIC's investment manager. In addition, section 22(b) would not apply to the fee or any portion thereof.

It appears likely that no-load funds would use the UFIC first. Many long-term bond or stock funds that distribute their shares through commissioned sales forces likely would have to restructure their sales compensation arrangements in order to operate as UFICs. A few broker-dealers have already reformulated sales compensation from large up-front payments to streams of payments, which would be more compatible with the UFIC structure. Given the flexibility of the UFIC, if investor demand for a simplified fee product is strong, we expect that the industry would use its creativity to devise distribution methods acceptable to commissioned sales forces that would allow long-term bond and stock funds to use the UFIC.

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## A. Rationale for the Unified Fee Investment Company

Investors today appear to have a heightened awareness of fund expenses and their effect on investment return, but at present bond and equity funds do not appear to compete on the basis of expenses, perhaps because of several factors that inhibit market pressure. This increased investor awareness is likely due partly to Commission actions in the past twenty years to relax restrictions on advertising generally by investment companies and to develop standards for disclosing and advertising fund performance.<sup>175</sup> These actions permitted the evolution of an information industry that tracks funds. Specialized newsletters are published by a host of organizations, and many financial and general interest publications provide extensive coverage and analysis of mutual funds, including periodic rankings of performance and fund expense ratios.

As a result of these changes, funds that have low expenses have enjoyed substantial growth,<sup>176</sup> and market forces appear to be a more effective restraint on expenses today than they were in the 1960's. The degree of restraint, however, varies among the three major fund types: money market funds, bond funds, and stock funds. Two factors appear to explain the variations. First, where the costs of owning mutual fund shares are clear-cut and there are few barriers to exit, investors have greater incentive to leave, and, consequently, fund sponsors must be vigilant about paring expense levels. Second, where expenses directly and substantially affect short-term performance, investors focus on expense levels; the less expenses affect short-term performance, the less investor scrutiny they receive.<sup>177</sup>

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<sup>175</sup>See Chapter 9.

<sup>176</sup>For example, assets under the management of the Vanguard Group, the lowest-cost producer in the mutual fund industry, grew twentyfold during the 1980's, from \$2.4 billion to over \$50 billion, twice the rate of the industry as a whole. SANFORD C. BERNSTEIN AND CO., **THE FUTURE OF THE MONEY MANAGEMENT INDUSTRY** 60 (1990) [hereinafter **BERNSTEIN REPORT**].

<sup>177</sup>The level of expenses, of course, varies widely among fund types. According to one fund group:

[Costs] tend, for example, to be higher in equity-oriented funds (where they are easy to overlook on any short-term basis), and lower in money market funds (where they account for substantially all of the difference in yield). The costs of taxable and tax-exempt bond funds fall between this range.

Vanguard Money Market Reserves, 1990 ANNUAL REPORT ii (1990). One writer contrasts the expenses of bond funds with those of stock funds by noting that "[b]ond funds usually have lower expense ratios than stock funds because they are not managed as aggressively." Carole Gould, **High Expenses: Sign of Weakness**, **N.Y.TIMES**, Mar. 4, 1990, at F-28.

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These factors converge for money market funds and consequently market forces appear to exert great downward pressure on money market fund expenses. Investors accurately perceive that the money market fund is a relatively homogenous product for which yield is a major purchase criterion. The typical money market fund has no sales loads, either front-end or contingent deferred, and either no or low rule 12b-1 fees and thus simple, intelligible expenses and no barriers to a dissatisfied shareholder's exit from the fund. To attract and retain investors, money market fund sponsors actively compete on yield. Expense differentials may account for as much as three quarters of the variation in money market fund yield and almost one half of the difference between the highest- and lowest-yielding money market funds.<sup>178</sup> Investor focus on money market fund expense levels is sharpened by advertising and media coverage, which provide significant information to facilitate yield comparisons, and emphasize that the level of fund expenses is a major determinant of yield. Substantial fee waivers by money market fund sponsors have been common in recent years, and further emphasize the relationship between expenses and yield.<sup>179</sup> In fact, the fee waivers are usually styled as the manager absorbing all fund expenses beyond a certain level (e.g., twenty-five basis points), resulting in a fixed, single fee.

There is less market pressure on the levels of fees with bond and stock funds than with money market funds. The variety of charges and operating and

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<sup>178</sup>See IBC/DONOGHUE'S MONEY FUND REPORT 1 (Aug. 10, 1990); BERNSTEIN REPORT, *supra* note 176, at 12. The effect of expenses on yield is likely to be further enhanced, as the recent amendments to rule 2a-7 (17 C.F.R. § 270.2a-7) have tightened the conditions of the rule relating to portfolio quality, maturity, and diversification, so that money market funds' portfolios (and rates of return) are likely to become increasingly fungible. See Revisions to Rules Regulating Money Market Funds, Investment Company Act Release No. 18005 (Feb. 20, 1991), 56 FR 8113.

<sup>179</sup>Carole Gould, *One Way Funds Can Inflate Yields*, N.Y. TIMES, June 23, 1991, at III-10 ("More and more funds are absorbing some expenses as part of marketing strategies intended to attract investors by inflating yields -- the amount that funds earn in interest after the expense charges are subtracted. As of April 30, [1991,] 7 of the 10 top-yielding money funds were subsidizing at least part of their expenses by charging investors less than the total amount spent to run the funds. And, on average, 7 of the 10 top money funds have done so for the last year . . .").

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distribution expenses of bond and stock funds are difficult to aggregate, cannot be readily compared among funds,<sup>180</sup> and cause investor confusion.<sup>181</sup> Today, bond and stock funds typically operate under an unbundled fee structure: they pay multiple fees for separate services provided under separate contracts. Of further confusion to investors, fees with the same label pay for different services. For example, some advisory contracts provide for portfolio management only. Other advisory contracts also provide for administrative, shareholder accounting, and transfer agency services. Compounding the labeling problem, particular fees are obscured by their placement in either the fund or the shareholder account, or by shifting their timing among point of purchase, investment period, and point of exit. Moreover, the sales loads (contingent or otherwise) and redemption fees charged by many bond and stock funds are perceived by investors as a penalty for taking one's money elsewhere and, as barriers to shareholders' exit, discourage competition for investors' dollars. Consequently, the competitive pressures on these funds appear to be less than on money market funds.

In addition, the relative investment performance of stock funds and, to a lesser degree, bond funds is not as significantly affected by expenses, at least in the short run, as is the performance of money market funds.<sup>182</sup> As a

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<sup>180</sup>Contributing to this difficulty, rule 12b-1 distribution fees currently are treated as an annual fund expense that is automatically included in annual return computations, while front-end loads and contingent deferred sales charges are sometimes included in calculations of total return and at other times are not included. For example, rule 482 (17CFR. § 230.482) permits mutual funds to advertise performance data that do not reflect sales loads or other nonrecurring fees, provided that the funds disclose that the performance data do not reflect their deduction, and that, if reflected, the loads or fees would reduce the performance quoted. Rankings of fund performance issued by various publications often do not reflect such charges.

<sup>181</sup>With the 1988 amendments to Form N-1A (see Inv. Co. Act Rel. 16244, *supra* note 85), the Commission required mutual funds to consolidate expense data in a fee table located near the front of each prospectus and to include additional disclosure regarding rule 12b-1 plans. These disclosures improve investor understanding of fund expenses and sales charges, but the different kinds of costs still frustrate direct comparisons.

<sup>182</sup>Bond funds' expense differentials account for a lesser, although still significant, proportion of the overall yield and total return variation than do those of money market funds. Bond fund yields are subject to greater variation than yields of money market funds because bond fund portfolio managers are not bound by the limits on portfolio quality and maturity mandated by rule 2a-7 and accordingly, their portfolios are not as homogenous. The expenses of bond funds, however, have different effects on yield than on total return. A bond fund's total return usually differs from its yield because the value of its portfolio varies with changes in the general level of interest rates and changes in the credit quality of the issuers whose securities it owns; the impact of interest rate and credit quality changes on portfolio value and on total return are greatest for bond funds with portfolios of long-term or low-quality bonds. Correspondingly, expenses have less effect on the total return of these funds, at least in the short run.

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consequence, investors appear to focus less on the expense levels of these funds than they do for money market funds.<sup>183</sup>

For these reasons, the Division has concluded that a new type of open-end investment company that has readily determinable and comparable expenses and minimal barriers to exit, like money market funds, would appeal to investors because of the simplicity of its fee and would foster competitive pricing among bond and stock funds. Accordingly, the Division recommends that the Commission propose amendments to the Act to permit the UFIC, an alternative type of mutual fund with a single fee. The UFIC would be subject to a lesser degree of fee regulation, and its simple fee structure would benefit both investors and sponsors. Fee disclosures for UFICs would be easy to prepare and

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<sup>182</sup>(...continued)

For stock funds, the impact on fund performance of expense differentials may be insignificant compared to the impact of portfolio gains and losses. See, e.g., Jonathan Clements, *Does Your Stock Fund Pass These Three Tests*, WALL ST. J., July 22, 1991, at C-1 ("With money funds and most bond funds, analysts say, the most important criteria are each fund's annual expenses . . . . But when it comes to hunting down a well-managed stock fund, analysts put a bit of emphasis on past performance, especially a fund's results over larger time periods such as five and ten years."); Letter from John C. Bogle, Chairman, The Vanguard Group of Investment Companies, to George A. Fitzsimmons, Secretary, SEC 11 (Mar. 9, 1983), File No. S7-955 (commenting on Investment Company Act Release No. 12888 which requested public comment on mutual fund governance) ("In stock funds, where annual performance differs by large magnitudes from one fund to another, total performance, not the expense ratio and its relatively modest impact on performance, is the focus of investor attention").

<sup>183</sup>Nonetheless, bond funds today compete in part on expense levels. The Bernstein Report gives this example:

Franklin [Resources, Inc.'s] municipal yields are among the best in the industry owing to fund expense levels of about 50 basis points versus an industry average of 80 basis points. . . . Virtually all of this pricing advantage relates to non-advisory expenses (transfer agent, custody, professional fees) which are spread over three funds with combined assets of \$16.5 billion. Franklin provides these services to the funds, and at cost.

BERNSTEIN REPORT, *supra* note 176, at 77. This report also states that "direct price competition increasingly makes sense for the largest firms, who enjoy scale advantages in name awareness, servicing costs and actual money management. We believe pricing will be a more important factor and therefore expect both sales loads and management fees on fixed income products to be under pressure." *Id.* at 12.

In addition, bond and equity index funds appear to compete on expense levels. The chief difference in yield or total return among such funds will be any difference in expenses.

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understand, and readily compared with those of other funds of the same type.<sup>184</sup> Additionally, the true cost of investing in the vehicle would be apparent, since distribution-related and other charges would be included in all published figures for fund yield and total return. From the perspective of sponsors and directors, bundling all costs of operation and distribution into a single fee also should reduce the time and expense of detailed accounting reports, legal analyses, and deliberations surrounding expenditures from fund assets that must be allocated for advisory, distribution, and other services.

## B. Operation of a Unified Fee Investment Company

The UFIC would be organized and operated as described below.<sup>185</sup>

### 1. Role of the "Investment Manager" and Parameters of the "Unified Fee"

A UFIC would be organized and operated by an "investment manager." The UFIC would be defined as a type of open-end investment company organized under the laws of any state or states, that is operated by an investment manager pursuant to a written contract in return for a unified fee. The term "investment manager" would be defined to distinguish the sponsor and manager of a UFIC from the investment advisers of other management investment companies. The term "investment manager" would be added, where appropriate, to provisions of the Act and rules that refer to a fund's "investment adviser."<sup>186</sup>

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<sup>184</sup>The benefits of a single fee fund and of off-the-page advertising (discussed in Chapter 9) would be mutually reinforcing. A unified fee vehicle would lend itself to off-the-page advertisements by simplifying the task of providing the relevant expense and historical performance information. The ability to advertise off-the-page would facilitate the use of single fee funds by providing an efficient means of informing investors of this alternative vehicle and promote price competition.

<sup>185</sup>As discussed in Chapter 7, some industry observers have previously advanced an alternative type of open-end investment company termed a unitary investment fund ("UIF"). The UIF would feature a fixed expense ratio or manager's fee, subject to a statutory cap, that would finance all fund expenses except for extraordinary expenses and transfer agency costs. The latter expense would be charged directly to each shareholder's account and not to the fund. Accordingly, the cost of investment in the UIF would be readily apparent to investors. Because the UIF would not have the protections provided by boards of directors and shareholder voting, would not diminish costs substantially, and would not significantly facilitate internationalization, we do not recommend it. As is evident from our present proposal, however, we believe that the single fee aspect of the UIF has merit, if accompanied by appropriate protections.

<sup>186</sup>For example, section 36(a) would be amended to include the investment manager among those persons whom the Commission may sue for breach of fiduciary duty involving personal misconduct.

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A written "management contract" between the investment manager and the UFIC would specify a single, unified fee payable to the manager in exchange for all services necessary for the UFIC's operation and bind the manager to provide or contract with third parties for these services. This fee would be subject to market pressure and the continuous "vote" of investors in the form of investor decisions to purchase or redeem shares. The fee would be computed as a percentage of fund assets and deducted from assets on a daily basis.

From an investor's perspective, the UFIC would be a "pay-as-you-go" vehicle. All costs of operating the fund and distributing its shares -- other than portfolio transaction costs and extraordinary expenses<sup>187</sup> -- would be financed by the investment manager out of the unified fee or its own resources.<sup>188</sup> Thus, UFIC investors could not be assessed sales charges of any type or redemption fees,<sup>189</sup> and the portion, if any, of the fee that could be spent on distribution would be within the discretion of the manager. The manager could not use fund brokerage to pay for services such as custody, or free credit balances to pay for transfer agency services. To facilitate election of UFIC status and because a unified fee structure obviates the need to unbundle costs, the UFIC would be exempt from section 12(b) and rule 12b-1.

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<sup>187</sup>Treating brokerage costs as a general fund expense would be contrary to the current approach of applying these costs to the cost basis of each individual security. It also would require an investment manager to set its fee rate at a level that would include compensation for executing the fund's securities transactions or contracting with others to perform this function. This exercise would entail a certain amount of guesswork, and once undertaken, it could lead to "reversechurning," as the manager's interest in actively managing the portfolio might wane, given that all transactions would reduce the manager's profitability.

To ensure clarity and comparability among UFICs, "extraordinary" expenses would be defined under Commission rules implementing the **UFIC**.

<sup>188</sup>Allowing shareholders to be directly assessed any operating costs would impair investors' ability to compare expenses -- the heart of any market-oriented reform of mutual fund fee arrangements. Thus, the fact that certain operating costs are variable, *i.e.*, they are affected by the number and level of activity of fund shareholders, does not justify their exclusion from the single fee.

The UFIC's fee structure bears some resemblance to a proposal put forth by John Markese of the American Association of Individual Investors in response to the Study Release. Citing investor confusion and comparability problems, Mr. Markese advocated limiting funds to a single asset-based distribution charge, capped at **0.50%** annually of the investor's holdings, and an investment management fee out of which fund advisers could pay for additional distribution costs to the extent of their profits. See John Markese, *A Simplified Fee Proposal*, AAII J., Aug. 1990, at 17. A large number of individual investors endorsed Mr. Markese's article in their comments on the Study Release.

<sup>189</sup>Of course, as with other mutual funds, redemption from UFICs may not be entirely cost free since UFIC shareholders may realize capital gains upon redemption.

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The terms of the management contract between a UFIC and its investment manager would be governed by new section 15(g). Section 15(g) would make it unlawful for any person to serve or act as a UFIC's investment manager except pursuant to a written contract which precisely describes all compensation to be paid under the contract, and would specify that such compensation shall be limited to a unified fee payable to the investment manager, "extraordinary expenses," as defined by Commission rule, and interest, taxes and portfolio transaction costs (*i.e.*, brokerage fees). The investment manager would have the discretion to change the fee on ninety days' advance notice to shareholders of any increase. A fee could not be changed until it had been in effect for a full year. The section would incorporate the requirements of sections 15(a) and 15(c) regarding director approval of the initial contract and any renewals, but would provide that, in approving the rate of the unified fee, the directors need only ensure it is not "unconscionable or grossly excessive." The section would also require that the contract provide, in substance, that it may be terminated at any time by the full board or by the independent directors, voting separately.

## 2. Limits on the Unified Fee

Because the unified fee would be subject to competitive pressures, it need not be limited by statute or rule, except that no fee should be so grossly excessive as to constitute a waste of corporate assets as that standard is understood under state corporate law.<sup>190</sup> Accordingly, section 36(b) would be amended to exempt UFICs, their sponsors, investment advisers, affiliated entities, and other persons identified in the section, and to prohibit only unconscionable or grossly excessive UFIC fees. Section 22(b) would also be amended to exclude UFICs from the NASD's "excessive sales load" rules.

We do not believe that the UFIC's investors need the protections of the defensive procedures generally followed by investment company boards to ensure compliance with section 36(b). The UFIC would have few barriers to competitive pricing, so that competition could be substituted for regulation. Its key features -- a readily determinable single fee and minimal exit barriers -- would permit the UFIC to be freed from the regulatory restraint of section 36(b), imposed to compensate for the limited competition that was ineffectual in restraining fee levels. Similarly, the unified fee would not be subject to section 22(b).

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<sup>190</sup>The Commission would enforce the prohibition to protect investors where market pressure proves an illusory check on a greedy investment manager. The limit would provide a uniform standard for all UFICs by essentially codifying state corporate law standards concerning "waste of corporate assets," which governed excessive advisory fee litigation before the enactment of section 36(b) in 1970. See generally 2 FRANKEL, *supra* note 45, at 252-262. See also *infra* note 194.

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### **3. Composition and Role of the Board of Directors**

Except as to fee issues, a UFIC generally would have the same types of operational conflicts and potential for overreaching by management that inhere in the structure of open-end investment companies.<sup>191</sup> Thus, UFIC shareholders, like shareholders in other management companies, would need the protection afforded by board oversight of management. Moreover, the UFIC structure would perhaps create or exacerbate some risks that are not present, or not to the same degree, in the standard mutual fund structure. This suggests that UFIC investors would have a somewhat greater need than other investors for a third party monitor to oversee management's activities, and would require particularly effective, independent, and investor-minded monitors to protect their interests.

The first potential risk is that the investment manager, which would have discretion to allocate the unified fee as it deems appropriate and need not disclose the method of allocation, might be tempted to skimp on the basic level of services needed to operate the UFIC to bolster its own profitability. Market pressures might not check the temptation because investors, who typically lack the expertise or incentive to assess the quality and level of fund services, could not police the manager's choices.

A similar risk is that if market pressures on fee rates were extreme, the investment manager might be tempted to cut back or eliminate basic services to keep the fund in business. These temptations could create serious investor protection problems, if, for example, the manager hired an incompetent custodian.

To protect investors against these various conflicts and the possibility of management overreaching, the UFIC, like other open-end companies, would have a board of directors, which would be elected by shareholders in accord with section 16(a).<sup>192</sup> To foster the requisite qualities of effectiveness, independence, and investor-mindedness, section 10 would be amended to require that two-thirds of the UFIC's directors be independent.<sup>193</sup> The UFIC sponsor would nominate

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<sup>191</sup> See Chapter 7.

<sup>192</sup>Section 16(a) requires that at least two-thirds of the membership of the board of directors consist of directors who have been elected by shareholders. 15 U.S.C. § 80a-16(a).

<sup>193</sup>We use the term "independent directors" to refer to individuals on the board of directors of a registered investment company who are not "interested persons," as defined in section 2(a)(19). In Chapter 7, we recommend that the proportion of independent directors that must be independent for management investment companies generally be increased to a majority from the 40% level section 10(a) today requires. 15 U.S.C. § 80a-10(a).

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the initial independent directors, but the UFIC's independent directors would be self-nominating as to any vacancies occurring once the UFIC was organized.

The duties of the board would include evaluating and approving the management contract. The board would be required to review the fee only to ensure that the fee was not "unconscionable or grossly excessive."<sup>194</sup> The board would not be required to engage in more extensive evaluation.<sup>195</sup> The board also would approve any management contract continuing in effect for a period of more than two years. The UFIC's independent directors would separately evaluate and approve the initial contract, and any renewal of the contract, and either the full board or the independent directors, voting separately, would be authorized to terminate the management contract at any time on sixty days' written notice. Given the proposed exemption of the UFIC from section 12(b) and rule 12b-1, the UFIC's board of directors would not be required to authorize, review, or evaluate the component of the unified fee representing asset-based distribution fees.

The Division also recommends that new section 15(g) specify that the board, including the independent directors voting separately, must approve and periodically review all material contracts the investment manager has executed with others furnishing services to the fund, to ensure provision of adequate services to the fund. It also would provide that either the full board or its independent directors may terminate a material contract at any time, on appropriate notice. Section 15(a) and 15(c) would be amended to state that the directors shall not review the fee provisions of any investment advisory contract. This material contract review would ensure that the UFIC is provided the level of services needed for its safe operation. To buttress this oversight authority, either the full board or its independent directors, voting separately, would be authorized to terminate each material contract at any time on sixty days' written notice.

In addition to their ongoing scrutiny of the management contract and of material contracts for fund services, the UFIC's directors would police actions of the investment manager (or of parties with which the manager has contracted for

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<sup>194</sup>We intend "unconscionable or grossly excessive" to be consistent with a corporate waste standard. See, e.g., *Saxe v. Brady*, 184 A.2d 602, 610 (Del. Ch. 1962) (the essence of a claim of corporate waste of assets is that the consideration received by the corporation is "so inadequate in value that no person of ordinary, sound business judgment would deem it worth what the corporation has paid" or that the fee is "unconscionable" or "shocking"). *Accord, Acampora v. Birkland*, 220 F. Supp. 527, 548-49 (D. Colo. 1963); *Grobow v. Perot*, 539 A.2d 180, 189 (Del. Sup. 1988).

<sup>195</sup>The degree of board review of the unified fee would thus be significantly less than that undertaken currently by the boards.

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fund services) that involve potentially serious conflicts that are not readily monitored by shareholders: the investment manager's method of portfolio valuation, permissible principal and agency transactions with affiliates, and a host of other operational matters. For example, investors in money market funds organized as UFICs would have the benefit of board oversight of the valuation process under rule 2a-7.<sup>196</sup> In this respect, their responsibilities would be identical to those of other mutual fund directors.

#### **4. Shareholder Voting Rights**

The UFIC's shareholders would be accorded all voting rights accorded shareholders in other registered open-end investment companies, except those regarding fee-related issues,<sup>197</sup> as to which UFIC shareholders would be entitled to notice sent not less than ninety days in advance of a proposal's implementation.<sup>198</sup> In addition, a fee could not be changed until it had been in effect for one year. Providing such notice would give investors the opportunity to approve or reject a fee-related proposal by remaining in the fund or redeeming their shares.<sup>199</sup> Streamlining these rights, with respect to fees, is consistent with protecting shareholders' interests through price competition and the ready redeemability of UFIC shares. Thus, it would not be necessary for the UFIC's shareholders to vote formally their approval, or termination, of the management contract, advisory or sub-advisory contracts, any new contracts resulting from assignment of prior management, advisory, or sub-advisory contracts, principal underwriting contracts or contracts with others for fund services. Nor would it be necessary that shareholders formally approve an increase in the unified fee. In each instance, shareholders would receive advance notice of a proposed fee increase or contractual change. Finally, given the UFIC's exemption from rule 12b-1, its shareholders would not be consulted as to whether the fee would be used for distribution-related purposes.

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<sup>196</sup>17 CFR. § 270.2a-7.

<sup>197</sup>Thus, our recommended changes to existing shareholder voting requirements for registered investment companies, generally, discussed in Chapter 7, would apply to the UFIC where they do not conflict with the more particularized requirements discussed here.

<sup>198</sup>The notice would be deemed a solicitation of a proxy, consent, or authorization for purposes of section 20(a) of the Investment Company Act (15 U.S.C. § 80a-20(a)), and would include all information now required to be included in a proxy statement.

<sup>199</sup>The Division considered substituting a notice requirement for the requirement of shareholder approval of matters that are not fee-related. We rejected this approach because exit from the UFIC is not entirely cost-free (see *supra* note 189) and because the manager, in complying with a notice requirement, would incur costs similar to those incurred in soliciting shareholder approval.

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Accordingly, the definition of "voting security" would be amended to include any security issued by a UFIC. Also, section 15(a) would be amended to state that an investment advisory contract or other contracts with a unified fee company for fund services need not be approved (initially or annually) by the UFIC's shareholders and that its shareholders are not authorized to terminate such contracts.

### C. Investor Protection Issues

We have considered four concerns that may be raised by the UFIC. As set forth below, we believe the concerns would be addressed by the recommended statutory amendments.

First, some may object that "bundling" the fee would leave investors without specific information as to the costs of particular aspects of a fund's operations. We do not see the harm, as we believe that relatively few investors can analyze the specific expense items in fund financial statements in a meaningful way. Indeed, the fee table in Form N-1A requires only that fund expenses be separated into three categories: "management" fees, rule 12b-1 fees, and other expenses.<sup>200</sup> In contrast, the benefits of introducing UFICs seem clear: increased investor and media focus on bottom-line fund expenses, in general, and their importance to investment performance, in particular.

Second, because the UFIC would not be mandated, but would be an optional form of organization for open-end companies, arguably it would introduce to an already complex market a vehicle that departs in significant respects from the current mutual fund model. To ameliorate concerns about introducing a new vehicle, the Division would monitor the operations of the first UFICs and report its findings to the Commission after three years. For monitoring purposes, we considered limiting eligibility for UFIC status to money market funds and relatively short-term bond funds, the types of funds whose fee rates are most subject to market forces and whose current structure most easily lends itself to conversion to the UFIC structure. On balance, we concluded that limiting the types of open-end companies that may organize as UFICs is unnecessary and would delay the introduction of competitive pressures on long-term bond funds and stock funds, the funds whose investors would most benefit from more competitive pricing.<sup>201</sup>

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<sup>200</sup>See Inv. Co. Act Rel. 16244, *supra* note 85.

<sup>201</sup>Of course, the differences in degree to which expenses affect the short-term performance of money market, bond, and stock funds suggest that eliminating sales charge and expense comparability problems among bond and stock funds, as well as significant barriers to their shareholders' exit, will promote the type of price competition among these funds that money market funds now exhibit, but not necessarily the same level of competition.

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Third, one could argue that permitting a "bundled" fee would afford investment managers the opportunity to build an excessive profit into the single fee, particularly for fund types whose investors de-emphasize fund expenses in their quest for the services of an investment manager with perceived stock- or bond-picking ability, if the market does not function efficiently to check the level of the fee. We believe that the market will work to keep fees at reasonable levels, given the single fee and minimal exit barriers, and that the statutory prohibition on an "unconscionable or grossly excessive" unified fee will protect investors should the market prove inefficient. We expect that a vigorous, competitive market would keep fees fluctuating within a range that is not excessive. As an alternative, we considered imposing a statutory maximum fee level, as was posited for the unitary investment fund, but concluded that a fee cap is unnecessary. Moreover, because expense levels vary greatly across different types of portfolios, a single cap would not be appropriate.

Fourth, some may argue that, because the investment manager would be responsible for paying for all services provided to the UFIC, it would have a strong incentive to contract with low-cost service providers. Investor protection risks would be created if these providers are not competent. As discussed above, we believe that interposing board review of all material contracts will address this concern.

## **V. Conclusion**

The Division recommends that the Commission pursue several legislative and rulemaking proposals designed to enhance competition and improve investor understanding of investment costs. We recommend legislation to end retail price maintenance and to permit a single fee investment company. We recommend rule changes to permit multiple class arrangements. Finally, we recommend that the Commission generally support the NASDs initiative to provide comparable regulation for all types of sales charges.

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## APPENDIX 8-A

### Proposed Amendment to Section 22(d) of the Investment Company Act

(new language is shaded; deleted language is struck through)

Section 22 [15 U.S.C § 80a-22].

\* \* \*

(d) No registered investment company shall sell any redeemable security issued by it to any person except either to or through a principal underwriter for distribution or at a current public offering price described in the prospectus, and, if such class of security is being currently offered to the public by or through an underwriter, no principal underwriter of such security and no dealer shall sell any such security to any person except a dealer, a principal underwriter, or the issuer, except at a current public offering price described in the prospectus. The Commission may make such rules and regulations limiting the sale of redeemable securities by registered investment companies, principal underwriters, and dealers at prices other than the public offering prices described in the prospectus as are necessary and appropriate for the protection of investors. Nothing in this subsection shall prevent a sale made (i) pursuant to an offer of exchange permitted by section 11 including any offer made pursuant to section 11(b); (ii) pursuant to an offer made solely to all registered holders of the securities, or of a particular class or series of securities issued by the company proportionate to their holdings or proportionate to any cash distribution made to them by the company (subject to appropriate qualifications designed solely to avoid issuance of fractional securities); or (iii) in accordance with rules and regulations of the Commission made pursuant to subsection (b) of section 12.

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## Chapter 9

# Investment Company Advertising

### I. Introduction and Summary of Recommendations

Investors today have a complex range of financial products and services from which to select, and competition is fierce among the many providers of financial services for investors' dollars. To compete effectively in this market, financial service providers, including investment companies and their sponsors, use advertising to inform the public about their products and services.

Like most issuers of securities, when a mutual fund or other investment company offers its shares to the public, its promotional efforts become subject to the advertising restrictions of the Securities Act of 1933.<sup>1</sup> Congress imposed these restrictions so that investors would base their investment decisions on the full disclosures contained in the "statutory prospectus,"<sup>2</sup> which Congress intended to be the primary selling document. Originally, the reach of the advertising restrictions was formidable. The Securities Act essentially prohibited all advertising other than the statutory prospectus and limited announcements called "tombstones," which only identified the existence of offerings and provided information on how to obtain a prospectus. Under current law, investment companies may advertise using certain types of information if the advertisements comply with certain "safe harbor" rules.

The advertising restrictions of the Securities Act cause special problems for many investment companies. Mutual funds continuously offer and sell their shares to provide an ongoing flow of capital into their portfolios and to enable them to meet redemption requests from outgoing shareholders. Unit investment trusts ("UITs") have active secondary markets in which the trusts' sponsors are continuously redeeming and selling the *trusts'* units.<sup>3</sup> These ongoing distribution practices contrast sharply with the more traditional underwritings in which set amounts of capital are raised through periodic offerings of limited duration. In

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<sup>1</sup>Securities Act of 1933, 15 U.S.C. §§ 77a-77aa. See Section II.A. of this chapter for a discussion of the pertinent Securities Act provisions.

<sup>2</sup>As used in this chapter, "statutory prospectus" means the full prospectus required by section 10(a) of the Securities Act. 15 U.S.C. § 77j(a). 'Section 10 prospectus' refers to any prospectus permitted under any subsection of section 10, and is not limited to a section 10(a) prospectus.

<sup>3</sup>See *infra* text accompanying note 29.

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the case of the latter, the advertising restrictions end with the offering. In the case of mutual funds and UITs, the advertising restrictions never end because the offering process, in effect, never ends.

In addition, because of the nature of their business, the effect of the advertising restrictions is more severe for investment companies than for other types of companies. Other companies, even when engaged in a public offering, are able to advertise their products, and thus gain name recognition with potential investors, because advertising that does not attempt to sell securities is not subject to the Securities Act. Investment companies, in contrast, do not sell products in the usual commercial sense. In fact, the very nature of an investment company is so inextricably tied to the securities it offers that almost any advertisement about the company is potentially an offer to sell its securities that must conform to the Securities Act's requirements.

The advertising restrictions of the Securities Act also affect direct-marketed funds more than funds sold through broker networks. Direct-marketed funds use print, radio, and television advertising almost exclusively to sell fund shares to investors, while broker-sold funds employ sales personnel who sell fund shares orally. The advertising restrictions of the Securities Act have a much greater impact on direct-marketed funds than on broker-sold funds because the Securities Act does not hold the oral representations of sales personnel to the same prospectus requirements<sup>4</sup> as it does written communications?

In recognition of these problems, and to better enable investment companies to market themselves, the Commission has adopted advertising safe harbor rules. The most important of these is rule **482**, which permits investment companies to advertise investment performance data.<sup>5</sup> Rule 482 advertisements, however, are "prospectuses" under section 10(b) of the Securities Act (so-called "omitting prospectuses")? which means that they may only contain information

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<sup>4</sup>As discussed *infra* at text accompanying note 52, however, oral representations are subject to the liability provisions of section 12(2) of the Securities Act.

<sup>5</sup>See *infra* text accompanying notes 20, 28, and note 70. In this chapter, "written" communications, advertisements, sales material, and offers include those made by means of print, radio, television, and any other means contemplated by section 2(10) of the Securities Act. 15 U.S.C. § 77b(10).

<sup>6</sup>17 C.F.R. § 230.482.

<sup>7</sup>15 U.S.C. § 77j(b).

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"the substance of which" is included in the statutory prospectus: and that they are subject to section 12(2) of the Securities Act,<sup>9</sup> which imposes liability for false or misleading statements of material fact ("prospectus liability"). Rule **134**, the so-called "tombstone rule,"<sup>10</sup> stands in contrast. Over the years the Commission has expanded this safe harbor to the point where today investment company tombstones may contain almost any type of information other than performance data. The expansion of rule **134** raises investor protection concerns. Unlike rule 482 advertisements, there is no requirement that the substance of tombstone advertisements be contained in the statutory prospectus. In addition, because tombstone advertisements are not prospectuses, they are not subject to section 12(2).

In view of the impact that the Securities Act's advertising requirements have on investment companies, and in view of the anomalous and not wholly satisfactory evolution of the advertising safe harbor rules, the Division has considered whether the Securities Act's advertising requirements should be modified as they apply to investment companies. After reviewing the public comments and considering a number of alternatives, the Division recommends replacing the rule 482, omitting prospectus with a new section 10 "advertising prospectus" for investment companies.<sup>11</sup> This investment company advertising prospectus, like the current rule 482 prospectus, would be permitted to advertise performance data. Unlike the rule 482 prospectus, however, the investment company advertising prospectus would not be limited to information "the substance of which" is contained in the statutory prospectus. Eliminating this requirement would permit investment companies to advertise more freely and creatively, and would result in the dissemination of more information to the investing public.

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<sup>8</sup>See 17 C.F.R. § 230.482(a)(2). This requirement stems directly from the status of rule 482 advertisements as "omitting prospectuses" under section 10(b). See *infra* note 54 and accompanying text.

<sup>9</sup>15 U.S.C. § 77l(2).

<sup>10</sup>17 C.F.R. § 230.134.

<sup>11</sup>The Commission would accomplish this either by amending rule 482 or by rescinding rule 482 and adopting a new rule. Because section 10(b) of the Securities Act only permits a prospectus "which omits in part or summarizes information in the [statutory] prospectus," and because the proposed investment company "advertising prospectus" arguably will not comply with this requirement, the Division recommends amending section 10 to give the Commission the express authority to adopt this new advertising prospectus.

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The Commission would maintain or increase the current level of investor protection by developing standards governing the content and other aspects of investment company advertising prospectuses. With respect to the advertisement of performance information in particular, the Commission will determine whether the standards in rule **482** are sufficient, or whether, given the elimination of the "substance of" requirement and the broader advertising that will ensue, additional standards are needed. In addition, because the investment company advertising prospectus will be a "prospectus" as defined in section 2(10) of the Securities Act, the information contained therein will continue to be subject to the liability provisions of section **12(2)** of the Securities Act. Finally, investment companies will still be required to deliver the statutory prospectus to investors prior to, or with, the earlier of the confirmation of the sale or the delivery of the security.<sup>12</sup>

In connection with the proposal for an investment company advertising prospectus, the Division also proposes rescinding those provisions of rule **134** that are applicable to investment companies only. The Division believes that much of the information currently advertised by investment companies in rule **134** tombstones would be more appropriately advertised in the new investment company advertising prospectuses, which would be subject to section **12(2)**.

The Division considered, but does not recommend, permitting investment companies to advertise subject only to the antifraud provisions of the Securities Act and the Securities Exchange Act of 1934.<sup>13</sup> The Division believes that investors should continue to have an express private right of action, subject to a reasonable care defense, as provided by section **12(2)** of the Securities Act.<sup>14</sup> Eliminating this private right of action would, in effect, require investors that are harmed by misleading advertisements to sue under rule 10b-5, which requires investors to prove "scienter" or an intent to deceive.<sup>15</sup> This would reduce the ability of investors to recover on the basis of misleading advertisements, and thus significantly weaken investor protection.

The Division also recommends that the Commission permit mutual funds to sell their shares "off-the-page," which would be similar to a practice currently permitted in the United Kingdom and certain other European countries. The advertising restrictions of the Securities Act unintentionally have had disparate effects on direct-marketed funds in relation to broker-sold funds, and, as a result,

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<sup>12</sup>See *infra* note 24 and accompanying text.

<sup>13</sup>Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-78ll.

<sup>14</sup>See *infra* note 50 and accompanying text.

<sup>15</sup>17 C.F.R. § 240.10b-5. See also *infra* note 53 and accompanying text.

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have put direct-marketed funds at a competitive disadvantage. "Off-the-page" advertisements would help address this problem.

Off-the-page advertisements (which, under the legislation we recommend, would be a form of "advertising prospectus") would allow investors the option of purchasing mutual fund shares directly from an advertisement by completing an application form included with the advertisement. Investors that choose to review the statutory prospectus before investing would complete a request form that also would be included with the advertisement. The advertisement would continue to be subject to liability under section 12(2) of the Securities Act and would be required to contain core information about the investment company, as the Commission prescribes by rule, such as historical performance data, levels of fees and expenses, and investment objectives. The investment company would still be required to deliver the statutory prospectus to investors prior to, or with, the earlier of the confirmation of the sale or the delivery of the security.

The Division believes that an off-the-page rule would produce better and more informative advertisements. Because core information about the funds would be standardized in advertisements for the first time, investors would have access to a new, widely circulated source of important information that could be used to make comparative judgments about their investment alternatives. Investors that wish to study the statutory prospectus before making an investment decision would receive it before investing, but investors that choose to purchase off-the-page would receive the statutory prospectus along with written confirmation of the sale. This practice would parallel the current requirements that apply to brokers who may sell securities by means of oral, rather than written, communications.

As an alternative, the Division considered whether the statutory prospectus should be required to be delivered prior to all mutual fund sales, including sales made on the basis of oral communications. The Division does not recommend this because the statutory prospectus is easily available to investors upon request and because the requirement would disrupt longstanding practice. In the absence of evidence that investors are dissatisfied with, or are being harmed by, the current system, an inflexible advance prospectus delivery requirement does not seem warranted.

This chapter begins by analyzing the current application of the Securities Act and the rules thereunder to investment company advertising. Next, it considers whether certain restrictive conditions in rule 482 should be eliminated and whether investment companies should be permitted to sell off-the-page. The chapter concludes with a brief discussion of other proposals the Division considered.

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## **11. Background**

### **A. Application of the Securities Act and Rules to Investment Company Advertising**

#### **1. General Considerations**

When Congress enacted the Investment Company Act of 1940,<sup>16</sup> the Securities Act already regulated the offer and sale of investment company securities. While the Investment Company Act contained provisions that either supplemented the Securities Act or harmonized the scheme of regulation under the two statutes, it did not make any fundamental changes in the way investment companies could distribute their shares to the public. As a result, even though investment companies, particularly mutual funds, almost certainly were not the type of issuer Congress had foremost in mind when drafting the Securities Act, investment companies continued to be subject to its provisions.<sup>17</sup>

The central provision of the Securities Act, section 5,<sup>18</sup> contains prohibitions regarding the use of interstate commerce to offer and sell securities to the public. Absent an exemption, under section 5(c) it is illegal for an issuer or underwriter to offer a security for sale to the public using jurisdictional means until a registration statement is filed with the Commission.

Section 5 also contains prohibitions regarding the dissemination of written selling material to investors during the offering period. Section 5(b)(1) makes it unlawful to use interstate commerce to transmit any prospectus relating to a security with respect to which a registration statement has been filed unless the prospectus meets the requirements of section 10 of the Securities Act.<sup>19</sup> "Prospectus" is broadly defined in section 2(10) to include any advertisement or other communication, "written or by radio or television, which offers any security

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<sup>16</sup>Investment Company Act of 1940, 15 U.S.C. § 80a.

<sup>17</sup>One possible explanation is that the predominant form of investment company in existence in 1940 was closed-end. See Chapter 11. Unlike open-end companies, closed-end companies usually engage in traditional underwritten offerings of a fixed number of shares, and in most cases do not offer their shares to the public on a continuous basis.

<sup>18</sup>15 U.S.C. § 77e.

<sup>19</sup>Section 10 and Schedule A of the Securities Act set forth specific information required in section 10 prospectuses, as modified by the rules and regulations of the Commission adopted pursuant to its powers under section 10.

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for sale or confirms the sale of any security.<sup>20</sup> Thus, advertisements are considered prospectuses under the Securities Act if they offer a security for sale. Because the term "offer" is defined and interpreted broadly to encompass any attempt to procure orders for a security,<sup>21</sup> written advertisements relating to a security or aiding in the selling effort with respect to a security generally must be in the form of a section 10 prospectus.

Investment companies primarily use two types of section 10 prospectuses: the statutory prospectus specified in section 10(a); and a prospectus permitted under section 10(b) that "omits in part or summarizes" information in the section 10(a) prospectus.<sup>22</sup> A security cannot actually be sold until the registration statement becomes effective,<sup>23</sup> and the section 10(a) prospectus must be delivered no later than the delivery of the security or the confirmation of the sale, whichever occurs first.<sup>24</sup>

There is a limited exception to the general requirement that written offers after the filing of a registration statement must be in the form of a section 10 prospectus. So-called "supplemental sales literature" may be used after the effective date of a registration statement if accompanied or preceded by the statutory prospectus.<sup>25</sup> Thus, advertisements not meeting the requirements of section 10 may be used after the effective date if the statutory prospectus is printed in the advertisement (or was sent previously to each person receiving the advertisement). In addition, the use of specific types of advertisements such as "tombstone" advertisements are permitted under very limited circumstances,

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<sup>20</sup>15 U.S.C. § 77b(10).

<sup>21</sup>Section 2(3) defines the term "offer" to include "every attempt or offer to dispose of, or solicitation of an offer to buy, a security or interest in a security, for value." 15 U.S.C. § 77b(3). See, also, e.g., *In the Matter of Carl M. Loeb, Rhodes & Co.*, 38 S.E.C. 843,848 (1950) (holding that the statutory definitions of "offer" and "prospectus" are intentionally broad so as to include any document designed to procure orders for a security).

<sup>22</sup>For a discussion of summary and preliminary prospectuses, see discussion *infra* at notes 43-44 and accompanying text, and note 70. See also *infra* note 58 for a discussion of generic advertisements and newsletters.

<sup>23</sup>Securities Act § 5(a), 15 U.S.C. § 77e(a).

<sup>24</sup>See Securities Act §§ 2(10), 5(b)(1)-(2), 15 U.S.C. §§ 77b(10), 77e(b)(1)-(2).

<sup>25</sup>Under section 2(10)(a), supplemental sales literature is not considered to be a prospectus, and thus is not subject to section 5(b)(1) of the Securities Act. Many investment companies use supplemental sales literature extensively, often as an insert in the prospectus.

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without prior delivery of the statutory prospectus.

The advertising restrictions and the prospectus delivery requirements are intended to foster an environment for making rational decisions based on the full disclosures contained in the filed registration statement.<sup>26</sup> The requirements also are intended to limit the potential for high pressure salesmanship, undue expectations, and appeals to emotion in the sale of securities.<sup>27</sup> It is possible, however, under the Securities Act to sell a security orally and to send the statutory prospectus later, either with the security or the confirmation of the sale (whichever is earlier), because section 5(b)(1) limits only the use of a prospectus, and "prospectus" is defined to include written -- but not oral -- communications. Thus, investors do not necessarily receive full, written disclosure before they decide to purchase a security.<sup>28</sup>

As discussed above, many investment companies are continuously subject to the advertising restrictions of the Securities Act. Mutual funds engage in continuous offerings. UITs are continuously subject to the Securities Act because the trusts' sponsors typically operate secondary markets in which sponsors offer to buy back trust units from existing unit holders and sell them to new unit holders. Because the sponsor, as the trust's depositor, is an "issuer" under section 2(4) of the Securities Act,<sup>29</sup> all offers and sales by the sponsor in the secondary market, unless otherwise exempt, are subject to the Securities Act.

The greater impact of the Securities Act on these investment companies compared to other issuers cannot be traced to any particular congressional concern. Instead, it is simply a product of a statute that treats issuers that distribute their shares continuously the same as issuers that distribute their shares periodically.

## 2. The Advertising Rules Before 1954

When Congress passed the Securities Act, securities professionals were reluctant to disseminate any written material about an offering for fear it would

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<sup>26</sup>See FEDERAL SUPERVISION OF TRAFFIC IN INVESTMENT SECURITIES IN INTERSTATE COMMERCE, H.R. REP. No. 85, 73d Cong., 1st Sess. 8 (1933) [hereinafter 1933 HOUSE REPORT].

<sup>27</sup>See *id.* at 2.

<sup>28</sup>The Commission has imposed requirements to encourage the pre-sale distribution of preliminary prospectuses, but the requirements do not affect the vast majority of mutual fund sales. See *infra* note 70 .

<sup>29</sup>15 U.S.C. § 77b(4).

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constitute an illegal offer?" Practitioners found it difficult to distinguish between disseminating information, which was permitted and encouraged, and solicitation, which was prohibited.

Within months of the Securities Act's passage, and continuing for years afterward, regulators provided guidance on the dissemination-solicitation distinction in the form of public releases. An early release originated the "red herring" theory, under which circulars, describing the security in the manner required for prospectuses but marked to show that they were informative only and did not offer any security for sale, could be used prior to the effective date of the registration statement.<sup>31</sup> Later, the red herring theory was extended to permit the dissemination of certain summaries, such as the "blue card" summaries prepared by statistical organizations.<sup>32</sup> Eventually, the Commission adopted a rule specifically providing for the use of red herring prospectuses on the theory that they did not offer a security for sale within the meaning of section 2(3) of the Securities Act.<sup>33</sup>

In addition to red herrings, certain advertisements could be circulated under a narrow exception contained in section 2(10)(b) of the Securities Act. That exception provided for a tombstone advertisement which stated from whom a section 10 prospectus could be obtained and, in addition, did no more than identify the security, state the price thereof, and state by whom orders would be executed.<sup>34</sup> The tombstone was regarded as a "mere announcement" that did not interfere with the intent of Congress that investors have a complete understanding of the transactions in which they were invited to participate.<sup>35</sup>

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<sup>30</sup>Originally the Securities Act prohibited all offers until the registration statement became effective.

<sup>31</sup>Offers of Sale Prior to Effective Date of Registration Statement, Securities Act Release No. 70, 1 Fed. Sec. L. Rep. (CCH) ¶ 3150 (Nov. 6, 1933).

<sup>32</sup>Distribution by Statistical Services of Bulletins Describing Securities, Securities Act Release No. 464, 1 Fed. Sec. L. Rep. (CCH) ¶ 3165 (Aug. 19, 1935); Circulation of Information in Registration Statements Prior to their Effective Date, Securities Act Release No. 802, 1 Fed. Sec. L. Rep. (CCH) ¶ 3175 (May 23, 1936).

<sup>33</sup>Adoption of Rule 131, Securities Act Release No. 3177, [1945-1947 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 75,720 (Dec. 5, 1946).

<sup>34</sup>Tombstones are not prospectuses under section 2(10) and thus are not subject to section 5(b)(1). See *supra* text accompanying note 20.

<sup>35</sup>See 1933 HOUSE REPORT, *supra* note 26, at 8.

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In the early 1950's, the Commission used its rulemaking powers to permit issuers to advertise in a context other than the limited statutory tombstone. The Commission adopted a rule providing for an "identifying statement," which resembled an expanded tombstone.<sup>36</sup> An identifying statement could contain up to sixteen categories of information (as opposed to three or four for tombstones), but was only required to contain a red herring-type legend and a tear-off form for requesting the statutory prospectus. According to Professor Louis Loss, issuers did not use identifying statements, particularly complete identifying statements, very often in newspaper advertisements, except for mutual funds which adapted the tear-off form to their traditional tombstone advertisements.<sup>37</sup>

The Commission at that time also adopted a more expansive rule providing for a "newspaper prospectus" to be used by foreign governments.<sup>38</sup> Unlike identifying statements, newspaper prospectuses could contain any information "the substance of which" was included in the registration statement. Eventually the Commission adopted procedures permitting certain qualified domestic issuers (but not investment companies) to use newspaper prospectuses. In many ways the newspaper prospectuses (which are still available today to foreign governments)<sup>39</sup> were very similar to modern day "summary prospectuses."<sup>40</sup>

### 3. Post-1954 Development of Special Rules for Investment Companies

Uncertainty among securities professionals regarding the use of written communications in connection with public offerings continued until **1954** when

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<sup>36</sup>Securities Act Release No. 3453 (Oct. 1, 1952), 17 FR 8898 (adopting rule 132). The theory underlying rule 132 was the same as the theory underlying the red herring, *i.e.*, that the advertisement was not an offer under section 2(3).

<sup>37</sup>1 LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION 402, n.47 (3rd ed. 1989). This adaptation was possible because of the overlap in the information permitted by the rule and the statutory tombstone exception. An advantage of the identifying statement was that it could be used before and after the effective date of the registration statement, whereas, at the time, tombstones were limited to the post-effective period. The distinction, however, held little significance for mutual funds because they did -- and still do -- most of their selling in the post-effective period.

<sup>38</sup>Newspaper Prospectuses for Foreign Governments, Securities Act Release No. 3425 (Aug. 27, 1951), 16 FR 8820. Newspaper prospectuses differed from identifying statements in that they could be used only in newspapers or periodicals after the effective date of the registration statement and were required to contain specific types of information.

<sup>39</sup>See 17 C.F.R. § 230.494.

<sup>40</sup>See *infra* notes 43-44 and accompanying text.

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Congress significantly amended the Securities Act.<sup>41</sup> Congress amended section 5 to permit offers during the so-called "waiting period," *i.e.*, the period after a registration statement is filed but before it becomes effective. This largely solved the dissemination-solicitation problem.<sup>42</sup> In addition, Congress added rulemaking authority to section 2(10)(b), permitting the Commission to adopt rules specifying additional types of information that could be included in tombstone advertisements, and amended section 10(b), directing the Commission to adopt rules providing for a prospectus that "omits in part or summarizes" information in the statutory prospectus. These changes codified the prior administrative actions taken by the Commission and set the stage for further rulemaking.

Shortly thereafter, the Commission used its new rulemaking authority in section 10(b) to adopt rules providing for summary prospectuses.<sup>43</sup> Investment companies, however, were not permitted to use summary prospectuses until 1972 when the form for registering mutual funds was amended to provide for their use. Even then, the summary prospectuses were required to contain a substantial amount of information that made their use impractical for advertising in mass media.<sup>44</sup>

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<sup>41</sup>Ch. 667, 68 Stat. 683 (1954).

<sup>42</sup>The dissemination-solicitation debate centered mostly on whether a communication constituted "jumping the gun," *i.e.*, making an offer before the offer legally could be made. Even after Congress legalized offers in the waiting period, a problem continued to exist in terms of discerning whether a communication was an offer, because, if a communication was an offer, it had to be in a permissible form.

<sup>43</sup>Adoption of Rule 434, Securities Act Release No. 3592, [1952-1956 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 76,371 (Nov. 10, 1955) (permitting blue card summaries); Adoption of Summary Prospectus Rule 434A and Amendments to Forms S-1 and S-9, Securities Act Release No. 3722, [1952-1956 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 76,415 (Nov. 26, 1956) (merging the concept of summary prospectus with the old concept of newspaper prospectus). In 1982, a new summary prospectus rule, rule 431, replaced the earlier rules. Adoption of Integrated Disclosure System, Securities Act Release No. 6383 (Mar. 3, 1982), 47 FR 11380. 17 C.F.R. § 230.431.

<sup>44</sup>Investment Company Advertising and Summary Prospectus for Investment Companies, Securities Act Release No. 5248 (May 9, 1972), 37 FR 10071. For current summary prospectus requirements for mutual funds, see Instructions as to **Summary** Prospectuses contained in Form N-1A, Fed. Sec. L. Rep. (CCH) ¶ 51,207.

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The Commission also exercised its rulemaking authority under section 2(10)(b) to adopt rule **134**, the tombstone rule.<sup>45</sup> The legislative history of the 1954 amendments to section 2(10)(b) demonstrates that Congress believed that the rulemaking power was needed to permit "appropriate variation" in the contents of tombstone advertisements with safeguards.<sup>46</sup> The legislative history indicates, however, that Congress still intended tombstone advertisements to be a simple means for soliciting inquiries for the statutory prospectus. Accordingly, when the Commission adopted rule **134**, the newly expanded tombstone advertisements still were quite limited in scope. They could not contain financial information, general descriptions of the issuer, or other information that might reflect the desirability of buying the security.

Because of these limitations, rule **134** was not very useful to investment companies until the Commission amended it, first in 1972<sup>47</sup> and again in 1974.<sup>48</sup> These amendments permitted tombstone advertisements to contain a description of a mutual fund's particular attributes and method of operation, as well as limited financial information such as net asset value as of the most recent practicable date. In 1975, the Commission again amended the rule to allow discussions of general economic conditions (e.g., inflation) as well as references to retirement plans or other specific investment goals that could be achieved through an investment in the fund.<sup>49</sup>

Today investment companies can include a broad range of information in rule **134** advertisements. Essentially the only information that investment companies may not include under rule **134** is performance information.

The almost annual amending of rule **134** in the early to mid-1970's reflected the tension between the desire of investment companies to advertise more and broader topics of information and the theory that the tombstone was a simple device for screening out investors interested in obtaining a prospectus. This tension intensified in the late 1970's, and the Commission came under increasing

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<sup>45</sup>Adoption of Rules 134 and 135, Securities Act Release No. 3568, [1952-1956 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 76,359 (Aug. 29, 1955). At the same time, the Commission rescinded the identifying statement rule, because rule 134 made that rule unnecessary.

<sup>46</sup>H.R. REP. NO. 1542, 83d Cong., 2d Sess. 22 (1954); S. REP. NO. 1036, 83d Cong., 2d Sess. 6 (1954).

<sup>47</sup>Sec. Act Rel. 5248, *supra* note 44.

<sup>48</sup>Investment Company Advertising and Statement Required in Prospectus, Securities Act Release No. 5536 (Nov. 4, 1974), 39 FR 39868.

<sup>49</sup>Investment Company Advertising, Securities Act Release No. 5591 (June 16, 1975), 40 FR 27442.

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pressure to permit the inclusion of performance information in tombstone advertisements.

The Commission was reluctant, however, to expand the tombstone rule further without imposing prospectus liability under section 12(2) of the Securities Act for false or misleading statements of material fact.<sup>50</sup> Because tombstones are excepted from the definition of prospectus, they do not appear to create liability under the two express private causes of action in the Securities Act for material misstatements and omissions. Section 11 applies only to effective registration statements (which include the statutory prospectus);<sup>51</sup> section 12(2) by its terms applies only to prospectuses (both statutory and otherwise) and oral communications.<sup>52</sup> Thus, sponsors, issuers, and underwriters using misleading tombstones probably are subject to private liability only if they act fraudulently or recklessly.<sup>53</sup>

The resolution of these tensions came in 1979 with the adoption of the so-called "omitting prospectus" rule, now rule 482, under the rulemaking power in

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<sup>50</sup>Section 12(2) imposes liability on persons who offer or sell a security in interstate commerce by means of a prospectus or oral communication which includes an untrue statement of material fact, or omits to state a material fact that is necessary under the circumstances in order to make the statements made not misleading, subject to a defense that the offeror/seller did not know and, in the exercise of reasonable care, could not have known, of the untruth or omission.

<sup>51</sup>Section 11 imposes liability not on sellers of securities but on issuers of securities, as well as a broad range of other persons including directors, underwriters, and consenting experts, such as accountants, for information contained in the effective registration statement. 15 U.S.C. § 77k. There are certain other differences between section 11 and section 12. For example, under section 11 issuers do not have the "reasonable care" defense that they have under section 12(2). For an in-depth discussion and comparison of liability under sections 11 and 12(2), see LOUIS LOSS, FUNDAMENTALS OF SECURITIES REGULATION 887-906 (2d ed. 1988).

<sup>52</sup>But see LOSS, supra note 51, at 892 n.19. Professor Loss raises the problem of a seller who uses the statutory prospectus, which tells the whole truth, but sends along supplementary selling literature (which, like tombstones, are not prospectuses) containing "a pack of lies." He finds it hard to believe a court would exalt a "drafting bug" over clear legislative intent and deny recovery under section 12(2).

<sup>53</sup>To prevail in a lawsuit under rule 10b-5 under the Exchange Act (which applies to tombstones), a plaintiff must prove that the defendant acted with *scienter*. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 (1976). Although section 17(a) of the Securities Act (15 U.S.C. § 77q(a)) essentially prohibits negligent misstatements or omissions in tombstones, most courts and commentators believe that an implied private right of action does not exist under section 17(a). See generally Loss, supra note 51, at 975-981.

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section 10(b) of the Securities Act.<sup>54</sup> Rule 482 permits investment companies to advertise any information "the substance of which" is included in the statutory prospectus. The "substance of" requirement relates directly to the word "omits" in section 10(b) of the Securities Act, upon which authority for the rule rests. The theory behind the "substance of" requirement is that an advertisement cannot be one that "omits" information from the statutory prospectus unless all of the information in the advertisement is derived from (*i.e.*, is the "substance of") information in the statutory prospectus.

The most significant effect of adopting the rule under section 10(b) of the Securities Act, rather than section 2(10)(b), was to attach private liability under section 12(2) for false or misleading statements in rule 482 advertisements.<sup>55</sup> Because advertisements under rule 482 are prospectuses, they carry liability under section 12(2), subject only to a reasonable care defense.

### B. The Interplay of Rules 482 and 134

In the fifty-two years since the enactment of the Investment Company Act, Congress and the Commission have attempted to accommodate the unusual requirements of investment companies within the federal securities laws. The result now is a somewhat anomalous situation in which one kind of advertisement, the rule 134 tombstone, may be used to promote investment company shares creatively, perhaps even irresponsibly, subject only to the antifraud provisions and to the prohibition against the inclusion of any performance information. While the rule 482 omitting prospectus advertisement may use performance information, the substance of the information also must be in the statutory prospectus, and is subject to the stricter liabilities of section 12(2) of the Securities Act.

Moreaver, although rule 482 permits mutual funds to advertise performance information, they may do so only because of an attenuated link to the "substance of" requirement. To make the rule workable, investment companies have not been required to put actual performance figures in the statutory prospectuses, which would have resulted in investment companies constantly having to "sticker" their section 10(a) prospectuses. Rather, advertisements are deemed to meet the "substance of" standard of rule 482 as

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<sup>54</sup>Advertising by Investment Companies, Securities Act Release No. 6116 (Aug. 31, 1979), 44 FR 52816.

<sup>55</sup>Section 10(b) of the Securities Act by its terms provides that section 10(b) prospectuses, even if filed with the registration statement, do not create liability under section 11 of the Securities Act. Section 11 imposes a tougher standard of liability on issuers of securities than section 12 imposes on sellers because, under section 11, issuers have strict liability. See *supra* notes 50-51.

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long as the section 10(a) prospectus describes the methodology used to calculate the performance figures.<sup>56</sup>

The interplay between rule 134 and rule 482 has some ironic and unintended consequences. When reviewing advertisements, employees of the National Association of Securities Dealers, Inc. must try to discern which rule the sponsor is or should be relying upon to publish the advertisement.<sup>57</sup> As a practical matter, the only distinguishing feature is the inclusion or absence of performance information. If an advertisement contains such information, it must conform to rule 482's requirements, including the "substance of" requirement. If an advertisement does not contain performance data, it may be subject only to rule 134.<sup>58</sup>

## 111. Recommendations

### A. "Investment Company Advertising Prospectuses"

The Division recommends replacing the rule 482 omitting prospectus with a new section 10 advertising prospectus, to be called an "investment company advertising prospectus" or "advertising prospectus." The salient feature of this new advertising prospectus is that, unlike a rule 482 omitting prospectus, the information contained therein would not be limited to information the "substance of which" is contained in the statutory prospectus. Eliminating this requirement will remove a substantial regulatory burden, and should permit investment companies to advertise more freely and to disseminate valuable information to investors.

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<sup>56</sup>See Dechert Price & Rhoads (pub. avail. Nov. 20, 1979).

<sup>57</sup>For the rules governing the filing of advertisements with the NASD, see Securities Act rule 497(i)(17 C.F.R. § 230.497(i)) and Article III, section 35 of the NASD Rules of Fair Practice, Nat'l Ass'n Sec. Dealers, Sec. Dealers Manual (CCH) ¶ 2195.

<sup>58</sup>Two other communication formats utilized by investment companies deserve mention. "Generic" advertisements, which do not name any particular fund, have been permitted since 1972 as a way to promote the investment company industry generally. Sec. Act Rel. 5248 (adopting rule 135a under the Securities Act), *supra* note 44. 17 C.F.R. § 230.135a. In addition, funds distribute newsletters that often combine articles of general interest (non-offering material or "free writing") with separately designated rule 134 and rule 482 material. The Division has issued guidelines for the preparation of newsletters. See Letter from Kathryn B. McGrath, Director, Division of Investment Management, Securities and Exchange Commission, to Matthew P. Fink, Senior Vice President and General Counsel, Investment Company Institute (Jan. 29, 1990).

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In order to accomplish this, the Division recommends adding a new subsection (g) to section 10 of the Securities Act, expressly authorizing the Commission to permit investment companies to advertise using this new advertising prospectus.<sup>59</sup> The Division believes legislation is desirable because section 10, as currently written, does not expressly authorize a prospectus the substance of which is not contained in the statutory prospectus. As already discussed, section 10(b) requires that the information in a section 10(b) prospectus "omi[t] in part or summariz[e] information in the [statutory] prospectus." Thus, section 10(b) clearly authorizes rule 482 "omitting prospectuses" and rule 431 "summary prospectuses." Dropping rule 482's requirement that the prospectus contain only information the substance of which is contained in the statutory prospectus arguably is not authorized by section 10(b). Assuming section 10 is amended, the Commission would then adopt the investment company advertising prospectus by amending rule 482 or by adopting a new rule and rescinding rule 482.

Eliminating the "substance of" requirement will not diminish investor protection. As a general matter, the "substance of" requirement does not, in itself, prevent misleading statements. The release proposing rule 482 states that advertisements can convey the same "idea" as the section 10(a) prospectus without using the same words, and that advertising "techniques" can be used even though the techniques are not themselves included in the section 10(a) prospectus.<sup>60</sup> These practices leave a great deal of room for underwriters and broker-dealers to rephrase information in ways that undermine the utility of the "substance of" requirement.<sup>61</sup>

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<sup>59</sup>A draft of proposed subsection (g) appears in Appendix 9-A at the end of this chapter. Congress also would need to make a technical, or conforming, amendment to section 2(10)(a) to add the words "or subsection (g)" after the words "subsection (b)." This would make clear that communications made under new subsection (g), like communications under subsection (b), would not be excepted from the definition of "prospectus" in section 2(10)(a).

<sup>60</sup>Advertising By Investment Companies, Securities Act Release No. 5833 (June 8, 1977), 42 FR 30379. Rule 482 was at that time designated as rule 434(d).

<sup>61</sup>Some would argue that the requirement is useful in that, in the course of its review of registration statements, the Commission may uncover certain information, such as an adviser's past performance record, that is included in a registration statement to meet the "substance of" requirement. The Division could then advise the registrant that such information would, in the Division's view, be misleading if used in advertisements to sell the fund. We believe that the "substance of" requirement is not necessary for this purpose. Rule 482 (or any successor rule contemplated herein) provides the opportunity for the Commission to address the misleading character of particular types of information without the "substance of" requirement. In addition, rule 156 provides guidance on certain types of representations made in sales literature (including all advertisements) that are most likely to be misleading for purposes of an investment company's compliance with the general antifraud provisions. 17 C.F.R. § 230.156.

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In addition, issuers may clutter statutory prospectuses with unnecessary information so that their omitting prospectuses satisfy the "substance of" requirement. Thus, the requirement actually may operate to obfuscate other, more important information in the statutory prospectus and to dissuade investors from reading it.

Because the proposed investment company advertising prospectus would still be a "prospectus," issuers and sponsors would remain liable for false or misleading statements of material fact under section 12(2) of the Securities Act. Also, the new subsection (g) would provide for the same summary suspension procedure as in section 10(b) of the Securities Act, permitting the Commission to take prompt action to prevent the use or distribution of unlawful or deficient advertisements. In addition, investment companies would still be required to deliver a copy of the statutory prospectus prior to, or with, the earlier of the confirmation of the sale or the delivery of the security.

Finally, the Commission would retain its ability to regulate any aspect of advertising in the advertising prospectus, such as performance claims, which are susceptible to being misused. In rule 482, the Commission has standardized the manner in which fund performance may be advertised. The Commission may retain those standards, which have worked well, without change, or may strengthen them in view of the expanded advertising that the proposed advertising prospectus would permit.

The Division also recommends that when the Commission adopts the new investment company advertising prospectus rule, it rescind the provisions of rule 134 (the tombstone rule) that apply only to investment companies. The new investment company advertising prospectus would provide sufficient flexibility so that investment companies could discuss topics, such as economic conditions, that currently are discussed in tombstones, but generally not in statutory prospectuses. The information would then be subject to prospectus liability, instead of only antifraud liability, which would increase investor protection.

## B. "Off-the-Page" Advertisements

The Division has concluded that the Securities Act and rule 482 currently create an unwarranted competitive disadvantage for direct-marketed funds. Direct-marketed funds must attract investor interest by complying with the requirements of a safe harbor rule such as rule 482. Investors who clip a rule 482 advertisement must complete a form requesting the statutory prospectus<sup>62</sup>

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<sup>62</sup>See *infra* note 68 and accompanying text.

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which is received days, or perhaps even weeks (depending on when the investor has time to complete the form), after the investor first becomes interested. Finally, either the customer or the fund must initiate further contact to close the sale. This process is expensive and time-consuming.

In contrast, investors that desire to purchase investment company shares from brokers based on oral communications need not request, or wait for, a statutory prospectus before buying; they only need to receive the statutory prospectus prior to, or with, the earlier of the confirmation of the sale or the delivery of the securities, both of which occur after the investor has made an investment decision.<sup>63</sup> Thus, Investor A may discuss various investment options at his broker's office or over the telephone and may actually purchase securities based on those discussions without receiving a prospectus until the confirmation of the sale. Investor B, who also may know what she wants to buy based on her own reading and research, but whose interest runs to a fund that is not sold by commissioned sales personnel, cannot make her purchase until she requests and receives the prospectus.<sup>64</sup> Investor B is unable to invest her money as quickly as Investor A.

The Division recommends amending rule 482, or adopting a new rule, to give investors the option of purchasing mutual fund shares directly from advertisements ("off-the page").<sup>65</sup> Off-the-page advertisements would be required to contain standardized, core information about the fund. Under an off-the-page system, an investor would be able to purchase securities by completing an application form included with the advertisement, and sending a check with the completed form. The statutory prospectus would be delivered with the confirmation of the sale, paralleling the current requirements that apply to sales entered into on the basis of oral, rather than written, communications. Of course, investors also would have the option of requesting the statutory prospectus before investing; every off-the-page advertisement would be required to contain a prospectus request box, just as the rule 482 advertisements do today.

Selling off-the-page would provide significant savings for direct-marketed funds, would increase competition, and would provide investors with a new source of important information about their investment alternatives. The Division believes an amendment to rule 482 (or adopting a new rule) providing specific

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<sup>63</sup>See *supra* text accompanying note 28.

<sup>64</sup>See *infra* note 68 and accompanying text.

<sup>65</sup>The Division does not anticipate recommending that closed-end funds be permitted to use the off-the-page option because they typically use a more traditional type of underwriting. See *supra* note 17. The Division recommends that the Commission request comment on whether other types of investment companies, such as UITs, should be able to sell off-the-page.

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requirements for selling off-the-page could be accomplished without statutory amendment.

Under the Securities Act as originally passed, the statutory prospectus occupied an elevated status as the only sanctioned selling document. Not only was there an affirmative obligation to deliver the prospectus to investors, there was a prohibition on using most other forms of written communications. As discussed above, in 1954, the strictness of the Securities Act regarding prospectuses was relaxed somewhat by amendments to section 10(b), which authorized the Commission to adopt rules providing for a prospectus that omits in part or summarizes information in the statutory prospectus. The statutory prospectus no longer was the only document that could be used to make offers.

The legislative history of the 1954 amendments to the Securities Act indicates that Congress, in authorizing section 10(b) prospectuses, was primarily concerned with legalizing offers during the waiting (or "pre-effective") period, when offers cannot be accepted. The legislative history does not discuss the role of section 10(b) prospectuses during the *post-effective* period, the period during which investment companies most extensively offer their shares, probably because traditional corporate underwritings sell out rapidly after the registration statement becomes effective, based on indications of interest received during the waiting period. There is nothing in the legislative history, however, that would indicate that section 10(b) prospectuses cannot form the basis for sales after the registration statement has been declared effective, as long as the liability provisions of sections 12(2) and 17 attach and the statutory prospectus is sent to the investor prior to, or with, the earlier of the confirmation of the sale or the delivery of the security.<sup>66</sup>

In adopting rules under section 10(b), such as the summary prospectus rule and rule 482, the Commission has stated its intent to provide additional means for disseminating information, but not to supplant the statutory prospectus as the primary selling document.<sup>67</sup> In effect, in the case of rule 482, this means that although offers based on rule 482 advertisements are legal, sales based on rule 482 advertisements cannot proceed directly. The rule contains several requirements preventing investment companies from using rule 482 advertisements to close a

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<sup>66</sup>See S. REP. NO. 1036, *supra* note 46, at 12; see also Hearings on S. 2846 Before a Subcomm. of the Senate Comm. on Banking and Currency, 83d Cong., 2d Sess. 31-32 (1954) (statement of Ralph H. Demmler, Chairman, SEC, regarding summary prospectuses).

<sup>67</sup>Sec. Act Rel. 3722, *supra* note 43 (adopting summary prospectus rule); Sec. Act Rel. 6116, *supra* note 54, (adopting rule 434(d), later renumbered rule 482).

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sale, the most important of which prohibits an application form from accompanying the **advertisement**.<sup>68</sup>

The Division recognizes the Commission's historical concern that the statutory prospectus be the primary selling document for securities transactions. Nonetheless, we believe that permitting off-the-page sales would promote increased dissemination of information, which would benefit the investing public. Off-the-page advertisements would be required to contain the most critical information in the statutory prospectus (although, as discussed below, the Division does not recommend restricting these advertisements to information contained in the statutory prospectus). These shortened versions of the statutory prospectus probably would be widely circulated and could be used by investors for comparative purposes. Moreover, as long as off-the-page advertisements are considered section 10 prospectuses for purposes of liability under section 12(2), and rule 482 (or a successor rule) adequately addresses the presentation of performance and other information in the advertisements, issuers would not be tempted to use this medium for misleading statements.<sup>69</sup>

In addition, there are convincing policy reasons favoring an off-the-page system for investment companies. Funds sold primarily by broker networks make full use of the treatment accorded oral communications under the Securities Act.<sup>70</sup> Direct-marketed funds, on the other hand, have access to potential

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<sup>68</sup>The application form, which contains shareholder account information, cannot be sent alone because it would be an illegal "prospectus" unless preceded or accompanied by the statutory prospectus. Rule 482 also contains requirements for a legend encouraging the investor to request and read the statutory prospectus before investing, as well as information on how to obtain a statutory prospectus.

<sup>69</sup>The Division also recommends that the Commission explore in rulemaking proceedings whether off-the-page advertisements should be subject to pre-filing and clearance requirements. Such requirements could lessen the possibility of misleading advertisements and would allow the Commission to monitor the **use** of off-the-page advertisements.

We also believe that **use** of off-the-page advertisements should be limited to mass media advertisements and not extended to mailings and similar solicitations. Where a fund sponsor chooses to mail prospective investors written materials, we believe it should be required to include a statutory prospectus.

<sup>70</sup>Brokers who offer orally, either in person or over the telephone, are permitted to deliver the section 10 prospectus after the investor has made an investment decision. This situation was addressed when the Commission began requiring the broad distribution by underwriters and brokers of preliminary prospectuses to investors. See rule 460 under the Securities Act (which does not apply to sales of certain investment company securities) and rule 15c2-8 under the Exchange Act. 17 C.F.R. § 230.460; 17 C.F.R. § 240.15c2-8. Preliminary prospectuses are not, however, widely used for sales of mutual fund securities because mutual funds generally do not  
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investors only through the print and broadcast media. Because sales through those media cannot be accomplished directly, these funds are at a disadvantage in reaching potential customers.

For an off-the-page system to work, the advertisements must be short enough to be economically feasible and yet convey enough information for investors to evaluate the investment. The success of the British off-the-page system suggests this can be done. Rule **7.25** of the British Conduct of Business Rules requires that off-the-page advertisements contain up to eighteen items of information, along with certain statements, if applicable.<sup>70</sup> These items include information regarding the minimum amounts that can be invested, sales charges, reinvestment options, redemption procedures, investment objectives, expenses, fees, and performance. Although these requirements are quite extensive, and the advertisements can take up half of a page or more of advertising space, the size of the advertisements has not prevented their use in the British press.

The Division believes that it would be appropriate to develop an off-the-page rule along the lines of the British rule. There is a limited universe of facts that are central to an investment in a mutual fund, particularly given the degree of standardization of the industry imposed by the Investment Company Act. The Division would anticipate working with the industry and investors through the rulemaking process to develop the presentation of core information in off-the-page advertisements. A similar exercise resulted in the development of a "fee table" for mutual fund prospectuses, which has proven extremely useful to investors. Much about the options for presenting information would be learned through the rulemaking process.

Investor protection issues arising from the ability to sell off-the-page also could be addressed through the rulemaking process. For example, the Commission may wish to consider imposing a "seasoning" requirement so that only funds that have been registered for a certain period of time, e.g., two or more years, could sell off-the-page. The Division also recommends that the rule continue to require the advertisements to carry legends regarding the availability of the prospectus, so that investors would be able to request the prospectus by clipping the advertisement or calling the fund, just as they do today. This

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<sup>70</sup>(...continued)  
begin marketing **until** after the registration statement becomes effective, and, in any case, the vast majority of offers as well as sales occur in the post-effective period when preliminary prospectuses are not used (because statutory prospectuses are available).

<sup>71</sup>See Securities and Investments Board (United Kingdom), the Financial Services (Conduct of Business) Rules 1987, rule 7.25.

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requirement gives investors the option to study the statutory prospectus before investing.

Another issue that would be appropriate to consider during the rulemaking process is whether, if off-the-page sales are permitted, investors should be allowed to rescind purchases within a specified period of time (e.g., mailing time plus five days) in order to allow for an appropriate review of the statutory prospectus. Purchase monies could be required to be held in escrow and not invested until the close of the waiting period. Alternatively, a system could be developed by which the investor would assume the risk of any fluctuation in share prices during the waiting period, but any sales charge would be returned if the investor chose to rescind.<sup>72</sup>

A further question for review is whether an off-the-page rule should permit information other than the required information and, if so, under what standards. If the rule permits other information, the Commission must determine whether that information should be limited to information included in the statutory prospectus. The Division would not now recommend that off-the-page advertising be so limited. We think the reasons for abandoning the "substance of" requirement for rule 482 (or any successor) advertising also apply to off-the-page advertising. Furthermore, the current multiplicity of rules governing investment company advertising creates unnecessary confusion and resulting costs.<sup>73</sup> If the "substance of" requirement were to apply to off-the-page advertisements, but not to investment company advertising prospectuses, the situation would become further confused.

Thus, the Division recommends that off-the-page selling be an option under rule 482 (or its successor) which, as expanded, would not be limited to information in the statutory prospectus. Alternatively, off-the-page could be limited initially to information that is required by rule to appear.

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<sup>72</sup>British rules do not require that an investor be able to rescind his purchase as long as that fact is disclosed, although British investment schemes may voluntarily provide for that privilege. The Division recommends a similar approach, but anticipates further study and comment.

<sup>73</sup>The concern centers mainly on the current rules as they apply to newsletters. A single newsletter may contain so-called "free writing" articles, separately designated rule 134 material, and separately designated rule 482 material. The existing multiplicity problem would be partially solved by deleting the investment company provisions of rule 134 and returning investment company "tombstones" to a more traditional format. See *supra* Section III.A.

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## **IV. Other Options Considered**

### **A. Requiring Prior Delivery of Mutual Fund Prospectuses**

The Division also considered whether statutory prospectuses for mutual funds should be required to be delivered to investors prior to sale. After considering the issue, the Division does not recommend an advance prospectus delivery requirement for mutual funds.

We recognize there are legitimate arguments in favor of such a requirement. Statutory prospectuses for mutual funds are uniquely available because mutual fund securities are virtually always for sale. The timetable of the offering and the method of distribution for mutual funds are completely different than those for traditional issuers. In the case of mutual funds, there is not the same urgency or need to minimize risks; underwriters and brokers are not "on the hook" for large blocks of securities that must be quickly distributed at the retail level because mutual fund securities are sold on a "best efforts" basis. The timing of the offering does not depend on "indications of interest" solicited during the waiting period. Finally, there is no reason to resort to the alternative disclosure tool of the preliminary prospectus because the great majority of offers, and all sales, occur after the effective date of the registration statement.

On the other hand, the prospectus is easily obtained by anyone requesting it. Indeed, investors who know what they want to buy may not appreciate having to wait until their brokers send them a statutory prospectus. With the thousands of funds currently available, brokers may not be able to keep adequate stocks of prospectuses on hand. If the broker had to take the extra step of obtaining the prospectus from the fund, the process of actually getting the investor's money invested could be slowed unnecessarily. In the absence of evidence that investors are dissatisfied with the current system, or are not adequately informed today, we believe the possible benefits to be derived from an advance prospectus delivery requirement do not justify the time delays, additional costs, and administrative burdens that would be imposed.<sup>74</sup>

### **B. Eliminating Liability under Section 12(2)**

Some have argued that investment company advertisements should not be subject to prospectus liability under section 12(2) of the Securities Act, and that

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<sup>74</sup>A prospectus delivery requirement prior to sale would increase costs to some degree because brokers would have to adopt new sales systems to keep track of when prospectuses are sent and when sales are made.

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investment companies should be able to advertise any information that is truthful and not misleading, subject only to the general antifraud provisions of the securities laws.<sup>75</sup> Proponents of this view suggest it would level the playing field between direct-marketed, whose written communications are subject to section 5(b)(1), and broker-sold funds, whose brokers' oral representations are not. This suggestion would do more than level the playing field, however, because oral representations are subject to section 12(2) liability for false statements. If the suggestion were implemented, that liability would no longer attach to written advertisements.

Proponents of this suggestion also argue that the antifraud provisions of the Securities Act and the Exchange Act are enough to protect investors. The Division strongly disagrees. Besides leaving investors without an express private right of action under the Securities Act,<sup>76</sup> the Commission would be left without a means to halt misleading advertisements under the summary suspension procedures authorized in section 10(b). The Division therefore recommends that the Commission not support legislation at this time that would expand investment company advertising in a way that would remove the protections of section 12(2).

## V. Conclusion

The Division recommends amending the Securities Act so that investment companies may advertise a wide range of information in the form of a section 10 "investment company advertising prospectus," including information that is not included in the statutory prospectus required by section 10(a). If the Securities Act is amended to permit broader advertising subject to prospectus liability, we believe investment company tombstones should return to a traditional format similar to that *of* other issuers. We also recommend that mutual funds be permitted to sell "off-the-page" directly from an advertisement.

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<sup>75</sup>See, e.g., Letter from Dechert Price & Rhoads to Jonathan G. Katz, Secretary, SEC 54-56 (Oct. 10, 1990), File No. S7-11-90.

<sup>76</sup>See *supra* notes 14-15 and 50-53, and accompanying text.

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## APPENDIX 9-A

### **Red-Lined Version of Proposed Amendment to the Securities Act of 1933**

(new language is shaded; deleted language is struck through)

#### Section 10[15 U.S.C. § 77j].

\* \* \*

(g) In addition to the prospectus permitted or required in subsections (a) and (b), the Commission may by rules or regulations deemed necessary or appropriate in the public interest or for the protection of investors permit the use of an advertising prospectus, for purposes of subsection (b)(1) of section 5, by an investment company registered under the Investment Company Act of 1940, or a business development company which is selling or proposing to sell its securities pursuant to a registration statement which has been filed under the Securities Act of 1933. The Commission may at any time issue an order preventing or suspending the use of a prospectus permitted under this subsection (g) pursuant to the procedures set forth in subsection (b) of this section.

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## Chapter 10

# Variable Insurance

### I. Introduction and Summary

The regulation of variable annuities and variable life insurance under the Investment Company Act<sup>1</sup> presents questions of application and interpretation that defy easy analysis? In many ways, the regulation of these products under the Act is a historical anomaly. The Investment Company Act naturally presents a statutory framework for the products and services that existed in 1940. Variable insurance products did not exist then in any form, and Congress did not anticipate their creation. Though Investment Company Act regulation of these products is appropriate, the differences these products present from more traditional investment company products are significant enough that the Act is the proverbial "round hole" into which the "square peg" of insurance products is forced.

The products themselves are extremely complex. Although explained in greater detail in Part II below, a brief description at the outset may be useful. Both variable life insurance and variable annuity premium payments are allocated to investment portfolios maintained by an insurance company in a segregated or "separate account."<sup>3</sup> A variable life insurance policy is similar to a whole life policy, except that the cash value and/or death benefit vary depending upon the investment experience of the separate account! An annuity is a contract under which an insurer, in return for a lump sum payment or a series of payments during the "accumulation" or "pay-in" period, agrees to make a series of payments to the contract owner for life or for a specified period, the "annuity" or "pay-out" phase of the contract. Under a variable annuity contract, the value of what the contract owner may receive during the pay-in and sometimes the pay-out period

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<sup>1</sup>Investment Company Act of 1940, 15 U.S.C. § 80a.

<sup>2</sup>We use the term "variable insurance" to include both variable life insurance and variable annuities.

<sup>3</sup>The separate account is distinct from the insurance company's general account, which funds all of the company's fixed insurance obligations. For a definition of the term "separate account," see Investment Company Act § 2(a)(37) (15 U.S.C. § 80a-2(a)(37)); see also rules .0-1(e), .6e-2(a), and .6e-3(T)(a) (17 C.F.R. § 270.0-1(e), .6e-2(a), and .6e-3(T)(a)).

<sup>4</sup>Unlike term insurance, which provides only a guaranteed death benefit payment, a whole life policy has both a cash value and a guaranteed death benefit. Generally, the cash value builds up to the policy face amount by age 100.

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depends upon the investment performance of the separate account into which his or her payments have been invested?

Because contract owners assume certain investment risks under variable contracts, the contracts are securities under the Securities Act,<sup>6</sup> and the separate accounts funding the contracts are investment companies under the Investment Company Act? In addition, a distributor of the contracts is a broker-dealer under the Securities Exchange Act,<sup>8</sup> and a person rendering investment advice to the separate account, if organized as a management company, is an investment adviser under the Investment Advisers Act? The contracts are also insurance contracts regulated under state law.<sup>10</sup>

Confronted with a product that did not fit neatly within the Investment Company Act, the Commission, in early administrative decisions, concluded that variable insurance contracts should be regulated as periodic payment plans.\*\*

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<sup>5</sup>For descriptions of the variable annuity, see generally *In re Variable Annuity Life Ins. Co. of Am.*, **39 S.E.C. 680,683-685 (1960)**; PAUL A. CAMPBELL, *THE VARIABLE ANNUITY; ITS DEVELOPMENT, ITS ENVIRONMENT & ITS FUTURE (1969)*; and George E. Johnson, *The Variable Annuity -- Insurance, Investment, or Both?*, **48 GEO. L. J. 641 (1960)**.

For descriptions of the variable life insurance contract, see generally Tamar Frankel, *Regulation of Variable Life Insurance*, **48 NOTRE DAME LAW REV. 1017 (1973)**; DIVISION OF INVESTMENT MANAGEMENT REGULATION, SEC, VARIABLE LIFE INSURANCE AND THE PETITION FOR THE ISSUANCE AND AMENDMENT OF EXEMPTIVE RULES (1973) [hereinafter **1973 REPORT**]; and SEC Request for Comments on Issues Arising Under the Investment Company Act of 1940 Relating to Flexible Premium Variable Life Insurance, Investment Company Act Release No. **13632** (Nov. 23, 1983), **48 FR 54043**.

<sup>6</sup>Securities Act of 1933, **15 U.S.C. §§ 77a-77aa**.

<sup>7</sup>See *infra* notes 29-32 and accompanying text. An insurance company separate account may be organized and registered under the Investment Company Act as an open-end management company or as a unit investment trust ("UIT"). Currently, the UIT is the more popular organizational structure.

<sup>8</sup>Securities Exchange Act of 1934, **15 U.S.C. §§ 78a-78ll**.

<sup>9</sup>Investment Advisers Act of 1940, **15 U.S.C. § 80b**.

<sup>10</sup>See, e.g., N.Y. INS. LAW § 4240 (McKinney 1985 & Supp. 1992); CAL. INS. CODE §§ 10506, 10506.3 (West 1972 & Supp. 1992); ILL. ANN. STAT. CH. 73 § 857.24 (Smith-Hurd Supp. 1991).

<sup>11</sup>With respect to variable annuities, see *In re Prudential Ins. Co. of Am.* (**41 S.E.C. 335, 348 (1963)**, *aff'd sub nom.* *Prudential Ins. Co. v. SEC*, **326 F.2d 383 (3rd Cir. 1964)**, *cert. denied*, **377 U.S. 953 (1964)**), and *In re Variable Annuity Life* (**39 S.E.C. at 700-03**), in which the Commission considered requests for exemptions from the periodic payment plan provisions of the Investment Company Act. Similarly, since the introduction of variable life insurance contracts, the  
(continued...)

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Periodic payment plans are, essentially, a means of purchasing investment company securities by installment and are subject to heightened Investment Company Act regulation. This enhanced regulation, which focuses on the types of sales and related charges allowed and the manner in which they may be deducted and, at times, refunded, goes beyond that imposed on ordinary mutual funds.<sup>12</sup>

Although variable insurance products fit within the literal definition of periodic payment plan certificates,<sup>13</sup> they are significantly different investment products. The net result is that the regulations applicable to periodic payment plans are in many ways ill suited for variable insurance. While the Commission has issued or adopted numerous exemptive orders and rules to address some of the inconsistencies, the basic problem, namely that these provisions were not drafted with variable insurance products in mind, persists.

Some of the resulting difficulties are primarily business concerns for the industry, and do not directly implicate the Commission's mandate to protect investors, but may harm investors mainly by reducing the choices available to them. For example, the industry argues that, because of current pricing and distribution requirements of Investment Company Act regulation, an insurer finds it difficult to price its variable life insurance contracts in a way that adequately reflects the heavy capital expenditure needed to establish and maintain a variable

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<sup>11</sup>(...continued)

Commission has regulated them as periodic payment plans. See Separate Accounts of Life Insurance Companies Funding Certain Variable Life Insurance Contracts, Investment Company Act Release No. **9104** (Dec. 30, 1975), **41 FR 2556** (proposing rule **6e-2** that would require variable life separate accounts to be treated as issuers of periodic payment plan certificates).

As used in this chapter, the term "periodic payment plan" refers only to the contractual plan, one of two forms of installment investing used by investment companies. The other type, the voluntary plan, was not subject to the many abuses that resulted in the enactment of sections **26** and **27** of the Investment Company Act (**15 U.S.C. §§ 80a-26, -27**) and is not discussed herein. For an explanation of the differences between contractual and voluntary plans, see SEC, PUBLIC POLICY IMPLICATIONS OF INVESTMENT COMPANY GROWTH, H.R. REP. NO. 2337, 89th Cong., **2d** Sess. **231-32** (**1966**) [hereinafter PPI REPORT]; SEC, REPORT OF SPECIAL STUDY OF SECURITIES MARKETS OF THE SECURITIES AND EXCHANGE COMMISSION, H.R. Doc. NO. **95**, Pt. 4, 88th Cong., 1st Sess. **174-79** (**1963**).

"Periodic payment plans, although rare today, were the source of serious abuses prior to **1940**. Under these plans, investors periodically contribute a pre-established amount to a UIT that invests in an underlying mutual fund. In the 1930's, periodic payment plans were offered primarily to low income investors who could not meet the minimum investment required by a mutual fund. See infra notes **37-46** and accompanying text.

<sup>13</sup>Both types of securities fall within the definition of periodic payment plan certificates in Investment Company Act section 2(a)(27).

life operation; nor may the insurer distribute its contracts on an equal basis with fixed-dollar life insurance. To be competitive, a variable life issuer must bear an extra burden on its capital and surplus. As a result, relatively few variable life contracts are offered to the public, and few insurers have entered the variable life insurance business.<sup>14</sup>

The following table<sup>15</sup> illustrates the estimated annual market share for new sales of scheduled premium variable life insurance and flexible premium variable life insurance<sup>16</sup> from 1976 to 1991.

**TABLE 10-1**  
**Estimate of Annualized New Premium<sup>1</sup> Market Share by Product**

	<u>1976</u>	<u>1977</u>	<u>1978</u>	<u>1979</u>	<u>1980</u>	<u>1981</u>	<u>1982</u>	<u>1983</u>	<u>1984</u>	<u>1985</u>	<u>1986</u>	<u>1987</u>	<u>1988</u>	<u>1989</u>	<u>1990</u>	<u>1991</u>
Universal Life <sup>2</sup>	--	--	--	--	--	2%	9%	18%	30%	38%	35%	27%	26%	27%	26%	26%
Variable Life <sup>3</sup>	--	--	--	--	--	1%	2%	2%	3%	3%	3%	3%	1%	1%	1%	1%
Variable Universal <sup>4</sup>	-	--	--	--	--	--	--	--	--	1%	3%	7%	7%	6%	6%	5%
Term	12%	14%	15%	16%	18%	19%	18%	15%	12%	11%	12%	12%	13%	13%	13%	13%
WholeLife	<u>88%</u> 100%	<u>86%</u> 100%	<u>85%</u> 100%	<u>84%</u> 100%	<u>82%</u> 100%	<u>78%</u> 100%	<u>71%</u> 100%	<u>65%</u> 100%	<u>55%</u> 100%	<u>47%</u> 100%	<u>47%</u> 100%	<u>51%</u> 100%	<u>53%</u> 100%	<u>53%</u> 100%	<u>54%</u> 100%	<u>55%</u> 100%

<sup>1</sup>Includes 10% of Single Premiums, excludes universal life excess (dump-in premiums).

<sup>2</sup>"Universal life," "term," and "whole life" are forms of life insurance that are not registered with the Commission.

<sup>3</sup>The first variable life (referred to in this Chapter as "scheduled premium variable life") insurance contract was sold in 1976.

<sup>4</sup>The first variable universal life (referred to in this Chapter as "flexible premium variable life") insurance contract was sold around 1985.

Source: Life Insurance Marketing Research Association

<sup>14</sup>Approximately 36 of the more than 2,000 life insurance companies in the United States currently offer variable life products, for an estimated total net asset value at December 31, 1991, of \$6.2 billion. Letter from Lipper Analytical Services, Inc. to Clifford E. Kirsch, Assistant Director, and Wendell Faria, Deputy Chief, Office of Insurance Products, Division of Investment Management, SEC (Mar. 30, 1992). Approximately 76 life insurance companies currently offer variable annuities, for an estimated total net asset value at December 31, 1991, of \$101.1 billion. *Id.*

<sup>15</sup>Table based on data compiled from Life Insurance Marketing and Research Association ("LIMRA"), *Monthly Survey of Life Insurance Sales in the United States* and facsimile from LIMRA to Thomas Bisset, Attorney, Office of Insurance Products, Division of Investment Management, SEC (Mar. 26, 1992).

<sup>16</sup>For an explanation of the distinction between scheduled premium variable life insurance and flexible premium variable life insurance, see *infra* note 56.

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Other problems with variable insurance regulation directly affect the Commission's responsibilities under the Act. A major concern for the Commission is the continuing need to separate "insurance-related" charges from "securities-related" charges and subject only the latter to comprehensive periodic payment plan regulation. With the enactment of the McCarran-Ferguson Act in 1945, Congress determined that regulation of the insurance industry was the exclusive prerogative of the states.<sup>17</sup> Primarily for this reason, the Commission seeks to focus its regulatory efforts exclusively on the securities elements of variable insurance products and to avoid regulation of the insurance elements. Securities-related charges and insurance-related charges, however, cannot be neatly divided for regulatory purposes. Some charges that the industry characterizes as insurance charges appear to have components that should be subject to Investment Company Act regulation. Further, so long as the Commission regulates only "investment-related" charges, insurance companies may evade charge limits by adjusting "insurance-related" or unregulated charges to the extent permitted by state law. These problems are compounded by significant differences in the degree of insurance protection provided by variable life insurance and variable annuities.<sup>18</sup>

For these and other reasons discussed below, the Division recommends a fundamental change in the regulation of variable insurance. The Division concludes that the regulation of specific charges under sections 26 and 27 of the Investment Company Act<sup>19</sup> is inappropriate for variable insurance, and recommends a more flexible approach in which the Commission would have jurisdiction over all contract charges in the aggregate. The Commission generally would no longer engage in an examination of individual contract charges and the manner in which they are deducted or refunded, but would have the authority to adopt whatever rules, governing the overall level of charges, become necessary. Specifically, the Division recommends that the Commission propose legislation that would grant the Commission jurisdiction over all contract charges, including discretionary rulemaking authority to establish standards for determining the reasonableness of aggregate contract charges and the manner in which they are deducted; amend sections 26 and 27 to exempt variable insurance contracts from

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<sup>17</sup>McCarran-Ferguson Act, 15 U.S.C. §§ 1011-1015.

<sup>18</sup>During the pay-in or accumulation phase, a variable annuity has a minimal insurance element and closely resembles a mutual fund. See *infra* Section III. D. Variable life contracts, by contrast, afford significant death benefit protection to insureds, particularly in light of recent tax law changes that eliminated important tax benefits for contracts without a significant insurance element. See Internal Revenue Code §§ 7702 (definition of life insurance contract), 7702A (definition of modified endowment contract), I.R.C. §§ 7702, 7702A.

<sup>19</sup>15 U.S.C. §§ 80a-26, -27.

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the specific charge limits of those sections; and require aggregate charges under the contracts to be reasonable and the insurer to so represent in its registration statement. The proposal would recognize that variable insurance contracts and periodic payment plan certificates are different products that should not be treated identically under the Investment Company Act. Rather, variable insurance separate accounts should be treated more like mutual funds, which are subject to more general prohibitions against excessive fees.<sup>20</sup> The Division's recommendation would not affect any other provision of the federal securities laws; investors would remain protected by the substantive and procedural protections of these laws.

This chapter begins with an overview of the regulation of variable insurance under the Securities Act and the Investment Company Act. The chapter then reviews the differences between periodic payment plans and variable insurance. The chapter next examines regulatory and practical problems that have developed as a result of the decision to regulate variable insurance as periodic payment plans and concludes that those problems warrant a different legislative approach for variable insurance. Finally, the chapter discusses the Division's proposal to regulate variable insurance charges on a basis more comparable to the regulation of mutual fund expenses.

## **11. Variable Insurance Products under the Federal Securities Laws**

### **A. Variable Annuities**

An annuity may be described simply as a contract under which an insurer agrees to make a series of payments for a specified period, either a fixed period or for the life of a designated individual. Under "immediate" annuities, payments begin shortly after the initial cash contribution. Under the more common "deferred" annuities, payments do not begin until some future date selected by the owner or set by the contract. Contract owners purchase these contracts by paying either single or periodic premiums.

The benefits under an annuity may be funded in one of two fundamental ways: fixed or variable. Under a fixed or "fixed-dollar" contract, the insurance company guarantees that a minimum rate of interest will be credited to the owner's account during the accumulation or pay-in period, and also guarantees that once the pay-out period begins, payments will be a certain guaranteed amount per dollar accumulated. Payments during the accumulation period of a

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<sup>20</sup>See, e.g., Investment Company Act §§ 22(b), 36(b), 15 U.S.C. §§ 80a-22(b), -35(b); rule 12b-1, 17 C.F.R. § 270.12b-1.

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fixed annuity are allocated to the insurer's general account, which is invested in accordance with state law. A variable annuity contract, by contrast, provides for values that vary directly with the investment performance of the contract owner's payments. Variable annuity premiums are invested in an insurer's separate account, which offers the contract owner a number of investment options. Payments to the contract owner during the pay-out period may be variable or fixed, depending on the annuity option selected.

### B. Variable Life Insurance

Variable life insurance is similar to whole life insurance, except that the cash value and/or death benefit vary depending on the investment performance of the separate account in which the premium payments are invested. Under a whole life policy, premium payments are allocated to an insurer's general account and invested conservatively (as required by state law) to ensure that the company is able to meet its death benefit and cash value guarantees. The investment return on assets in the general account has little or no direct effect on the cash value and on the death benefit received.

Premium payments under a variable life policy, in contrast, are invested in an insurance company separate account, which is not subject to state requirements that the assets be invested conservatively. A variable life policyholder typically is offered a variety of investment options to choose from (*e.g.*, money market, equity, and bond funds). Death benefits and cash values are directly related to performance of the separate account, although typically there is a minimum below which the death benefit is guaranteed not to fall. Variable life policies have either scheduled or flexible premiums, although the flexible premium policy is more common today. Under a scheduled premium contract, premiums are fixed as to both timing and amount. Under a flexible premium policy, also called a variable universal life policy, the policyholder may vary the amount and the frequency of policy premiums as well as the level of death benefit protection.

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## C. The Introduction of Variable Products

Until variable insurance was developed, there was little controversy over whether insurance contracts were securities subject to regulation under the federal securities laws.<sup>21</sup> Section 3(a)(8) of the Securities Act<sup>22</sup> exempts traditional or "fixed" insurance contracts from registration if they are issued by a corporation subject to state insurance regulation.<sup>23</sup> Similarly, section 3(c)(3) of the Investment Company Act<sup>24</sup> excepts from the definition of investment company any company organized as an insurance company that has as its primary and predominant business activity the writing of insurance and is subject to supervision by an appropriate state authority.<sup>25</sup>

When variable annuities were introduced in the 1950's, the Commission took the position that these products were securities. The industry disagreed. The issue was decided by the Supreme Court, which held that variable annuities are securities under the Securities Act, not exempted insurance contracts.<sup>26</sup> The Court determined that insurance required "some investment risk-taking on the part of the [insurance] company. . . [and] a guarantee that at least some fraction

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<sup>21</sup>Historically, insurance has been the exclusive preserve of state regulation. In *Paul v. Virginia* (75 U.S. (8 Wall.) 168, 183 (1868)), the Supreme Court determined that issuing a policy of insurance is not a transaction of commerce. The Court's decision laid the groundwork for the development of state regulation of insurance over the next several decades on the basis that Congress had no authority under the commerce clause to regulate the business of insurance. When *Paul v. Virginia* was subsequently overruled in *United States v. Southeastern Underwriters Ass'n* (322 U.S. 533 (1944)), Congress promptly enacted the McCarran-Ferguson Act to preserve state regulation of insurance.

<sup>22</sup>15 U.S.C. § 77c-3(a)(8).

<sup>23</sup>The Commission has taken the view that an insurance contract falling within section 3(a)(8) is excluded from all provisions of the Securities Act, even though the section by its terms is an exemption from only the registration provisions of the Act. See, e.g., Definition of "Annuity Contract or Optional Annuity Contract," Securities Act Release No. 6558 (Nov. 21, 1984), 49 FR 46750 (proposing rule 151). The legislative history of the Securities Act supports this view (see HOUSE COMM ON INTERSTATE AND FOREIGN COMMERCE, FEDERAL SUPERVISION OF TRAFFIC IN INVESTMENT SECURITIES IN INTERSTATE COMMERCE, H.R. Rep. No. 85, 73rd Cong., 1st Sess. 15 (1933)), as well as the Supreme Court in dicta (see *Tcherepnin v. Knight*, 389 U.S. 332, 342 n.30 (1967)), and at least one commentator (see LOUIS LOSS, FUNDAMENTALS OF SECURITIES REGULATION 204-05 (2d ed. 1988)).

<sup>24</sup>15 U.S.C. § 80a-3(c)(3).

<sup>25</sup>The term "insurance company" is defined in section 2(a)(17) of the Investment Company Act.

<sup>26</sup>*SEC v. Variable Annuity Life Ins. Co.*, 359 U.S. 65/71-73 (1959) [hereinafter "VALIC"].

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of the benefits will be payable in fixed amounts.<sup>27</sup> Because the variable annuity contracts at issue placed the entire investment risk on the contract owner rather than the insurance company, the Court concluded that the contracts were securities.<sup>28</sup> The Court also determined that the insurance company, which sold only variable annuities, was an investment company under the Investment Company Act.<sup>29</sup>

A few years later, the Commission considered whether an insurance company that sold both variable annuities funded by a separate account and traditional insurance products funded by the general account was an investment company under the Investment Company Act.<sup>30</sup> The Commission concluded that the separate account funding the variable annuities was an investment company, but that the insurance company itself could continue to rely on the exception in section 3(c)(3).<sup>31</sup> On appeal, a federal court affirmed the Commission's decision.<sup>32</sup>

In the early 1970's, the insurance industry introduced variable life insurance. After extensive public hearings, the Commission concluded that

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<sup>27</sup>*Id.* at 71. Similarly, in SEC v. United Benefit Life Ins. Co. (387 U.S. 202, 211-12 (1967)), the Court held that a deferred annuity that offers an insubstantial guarantee in the accumulation phase is subject to the Securities Act.

<sup>28</sup>VALIC, 359 U.S. at 71-73. In a concurring opinion, Justice Brennan concluded that state insurance laws, which focus on such matters as solvency, reserves, and contract terms, are inadequate substitutes for the disclosure requirements and other protections of the federal securities laws. *Id.* at 78, 85.

<sup>29</sup>*Id.* at 67-68, 71-73.

<sup>30</sup>In re Prudential, 41 S.E.C. 335. It was unnecessary to reach the section 3(c)(3) issue in VALIC because the company in VALIC issued only variable annuities and had no basis for relying on the exemption.

<sup>31</sup>*Id.* at 339-41.

<sup>32</sup>See Prudential Ins. Co. v. SEC, 326 F.2d at 383. The Commission's reasoning in that case is sometimes called the "ectoplasmic theory." See LOSS, *supra* note 23, at 208-09; Thomas J. Finnegan & Joseph P. Garner, *The Separate Account as an Investment Company: Structural Problems of the "Ectoplasmic Theory,"* 3 CONN. L. REV. 106 (1970). Under the ectoplasmic theory, the issuer of a variable annuity is the separate account and the insurance company is deemed to be the writer of the contract (In re Prudential, 41 SEC at 345), and the creator of the fund (*id.* at 340-41). Under section 2(4) of the Securities Act (15 U.S.C. § 77(b)(4)), the depositor of a UIT is considered to be the issuer of its securities. Accordingly, a separate account organized as a UIT and the insurance company/depositor are considered co-issuers of a variable insurance contract or the units of participation in the separate account.

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variable life insurance contracts are securities required to be registered under the Securities Act.<sup>33</sup> In light of the variable death benefit and cash value features of the contracts, the Commission concluded that variable life insurance contract owners assume a substantial investment risk.<sup>34</sup>

An early Commission decision noted that variable annuities, when purchased on an installment basis, provided for "periodic payments, redemption and undivided interests in a unit or fund of securities," characteristics common to periodic payment plan certificates.<sup>35</sup> The Commission made similar comparisons when variable life insurance was introduced.<sup>36</sup> In light of these comparisons, the Commission regulates variable insurance products as periodic payment plans under sections **26** and **27** of the Investment Company Act.

#### **D. Periodic Payment Plans**

Sections **26** and **27** address the abuses that were endemic in the periodic payment plan industry prior to 1940. The plans are contracts for investing in the shares of open-end investment companies on an installment basis.<sup>37</sup> Before enactment of the Investment Company Act, the most serious abuses associated with the plans resulted from the manner in which the sales load was deducted. An investor purchasing shares in a mutual fund directly would typically incur a sales load deducted as a simple percentage of his or her current investment. An investor buying through a periodic payment plan, in contrast, had his or her total sales load calculated as a percentage of the total amount to be invested over the

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<sup>33</sup>Exemption of Certain Variable Life Insurance Contracts and Their Issuers from Federal Securities Laws, Investment Company Act Release No. **7644** (Jan. 31, 1973), 38 FR **4315**.

<sup>34</sup>*Id.*

<sup>35</sup>In re Prudential, **41** S.E.C. at **348**. See also In re Variable Annuity Life, **39** S.E.C. at **683, 700-03**. Cf. PPI REPORT, *supra* note **11**, at **226-27**. The Supreme Court had previously noted the resemblance of variable annuities to periodic payment plan certificates. VALIC, **359 U.S.** at **85, 96** (Brennan, J., concurring, and Harlan, J., dissenting).

<sup>36</sup>The Division's **1973** Report on variable life insurance concluded that "the separate account formed to fund variable life insurance contracts would be an open-end management investment company issuing a periodic payment plan certificate." **1973 REPORT**, *supra* note **5**, at **128** (footnote omitted).

<sup>37</sup>The security directly purchased by an investor is the periodic payment plan certificate, which represents an undivided interest in, rather than direct ownership of, shares of an open-end investment company. See Investment Company Act § **2(a)(27)**. Plans typically have a two-tier structure under which payments are invested in a UIT, which invests in an underlying mutual fund. PPI REPORT, *supra* note **11**, at **226**.

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life of the plan (often ten or more years), rather than as a percentage of each individual payment. The plans deducted a proportionately higher amount from early payments, in order to encourage marketing efforts by salesmen. The net result was that little of the early payments under the plans was left for actual investment. Frequently, plans either were terminated or lapsed long before completion of planned payments. Since there was no requirement to refund excess sales loads, investors paid effective loads substantially in excess of the loads contemplated for completed plans. In other words, an investor who stopped making payments under a plan ended up paying a sales load on a larger investment than he actually made.<sup>38</sup>

The structure of the plans caused other abuses as well. Plan investors paid double sales loads: a primary sales load when they purchased interests in the unit investment trust ("UIT") and a second load when the trust purchased shares of the underlying mutual fund.<sup>39</sup> These double loads also were paid on dividend reinvestments.<sup>40</sup> In addition, the sponsor often deducted a fee for "managing" the UIT assets even though these were non-discretionary accounts and management fees were paid to the adviser of the underlying fund.<sup>41</sup> Plan investors paid other miscellaneous fees, such as withdrawal fees and a trustee's charge.<sup>42</sup>

Although section 27 permits the higher initial sales loads needed to market periodic payment plans, it addresses abuses common to the plans by establishing a maximum sales load, the manner of deducting sales charges, and refund requirements that return a portion of the load paid by planholders that terminate early.<sup>43</sup> It also subjects a periodic payment plan certificate issued by a

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<sup>38</sup>SEC, INVESTMENT TRUSTS AND INVESTMENT COMPANIES, COMPANIES SPONSORING INSTALLMENT INVESTMENT PLANS, H.R. DOC. NO. 482, 76th Cong., 2d Sess. 33-34 (1940) [hereinafter INSTALLMENT INVESTMENT PLAN STUDY].

<sup>39</sup>*Id.* at 40. If the underlying fund was not affiliated with the plan's sponsor, the plan sponsor typically kept the commission or discount included in the underlying fund's offering price rather than passing the discount on to plan investors. If the plan sponsor also managed the underlying fund, the sponsor typically assessed a full load when the trust purchased the *fund's* shares.

<sup>40</sup>*Id.* at 45.

<sup>41</sup>*Id.* at 38.

<sup>42</sup>*Id.* at 37, 43.

<sup>43</sup>Investment Company Act §§ 27(a), 27(d), 15 U.S.C. § 80a-27(a), -27(d). In addition, section 2(a)(35) of the Act prevents duplicative sales loads by requiring sales loads at the underlying fund level and the trust level to be combined for the purpose of meeting statutory limits.

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management company to the charge limitations established for UITs under section 26.<sup>44</sup> Section 26 prohibits the payment of any amount from trust assets to the depositor or principal underwriter for the trust unless the payment qualifies as reasonable compensation for performing certain bookkeeping or other administrative services.<sup>45</sup> Section 26 also limits the trustee's or custodian's fees to those fees and expenses set forth in the trust instrument and actually incurred.<sup>46</sup> No other charges are allowed.

## **E. Application of Sections 26 and 27 to Variable Insurance Products**

### **1. Variable Annuities**

A typical variable annuity contract assesses four types of charges: (1) front-end, deferred, and/or contingent deferred sales loads; (2) administrative expense charges; (3) mortality and expense risk charges; and (4) investment related charges, such as investment advisory fees. Advisory fees are subject to the fiduciary obligations imposed under section 36(b) of the Investment Company Act, which applies generally to all investment companies.<sup>47</sup> Sales loads, administrative charges, and mortality and expense risk charges, however, are regulated primarily under sections 26 and 27 of the Investment Company Act.

#### **a. Sales Loads**

The sales load limitations for periodic payment plans, and therefore variable annuities, are complex. Section 27(a)(1) limits issuers to a load not to exceed nine percent of total premium payments.<sup>48</sup> Section 27(a)(2) permits an issuer to deduct more than nine percent from a particular premium (as much as fifty percent of the first twelve monthly premiums) but only if (1) no subsequent sales load deduction exceeds a prior one;<sup>49</sup> (2) the contract contains a provision

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<sup>44</sup>Investment Company Act § 27(c)(2), 15 U.S.C. § 80a-27(c)(2).

<sup>45</sup>Investment Company Act § 26(a)(2), 15 U.S.C. § 80a-26(a)(2).

<sup>46</sup>*Id.*

<sup>47</sup>Section 36(b) is described in greater detail in Chapters 7 and 8.

<sup>48</sup>But see NATIONAL ASSOCIATION OF SECURITIES DEALERS MANUAL - RULES OF FAIR PRACTICE, Art. 111, § 29(c) (1984) (limiting the maximum sales charge for variable annuities to 8.5% of total payments) [hereinafter NASD RULES].

<sup>49</sup>Investment Company Act § 27(a)(3), 15 U.S.C. § 80a-27(a)(3). This is known as the "stair step provision."

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that permits the owner to surrender the contract within the first eighteen months and obtain a refund of some portion of the excess sales load assessed.<sup>50</sup> and (3) the period over which the life of the contract is measured for compliance with the nine percent limitation does not exceed twelve years.<sup>51</sup> An issuer may elect to use a "spread load" design, in accordance with the requirements of sections 27(g) and (h), and thus avoid the refund requirements of section 27(d).<sup>52</sup>

### **b. Administrative Expenses**

Administrative expenses under a variable annuity are regulated closely. Under section 26(a)(2)(C), administrative fees must be reasonable, as determined by the Commission. Rule 26a-1 defines reasonable administrative expenses for a separate account funding variable annuities, in essence providing that sponsors may not make a profit on administrative expenses. The rule limits administrative fees to the cost of services to be provided for one year in cases where the separate account reserves the right to increase the fee, or to the average expected cost for a specified period where the fee is guaranteed not to increase for that time.

### **c. Mortality and Expense Risk Charges**

Variable annuity issuers deduct a mortality and expense risk charge from the assets of a separate account to compensate the insurer for the "mortality" risks and "expense" risks it assumes under the contracts. The insurer assumes a mortality risk when it guarantees annuity rates to contract owners. These annuity rates are based on mortality projections for future annuitants. In the event that actual mortality rates differ from projections (*i.e.*, annuitants live longer than expected), the insurer remains obligated to pay annuity benefits as guaranteed in the contract. Some insurers also assume a mortality risk by agreeing to pay a

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<sup>50</sup>Section 27(d) requires the insurer to refund any sales load exceeding 15% of gross premiums paid by a contract owner. To assure payment of refunds, rule 27d-1 requires the insurer to keep certain reserves in a segregated account. 17 C.F.R. § 270.27d-1. Alternatively, under rule 27d-2 the insurer may undertake to refund excess sales load if it meets certain capital and reporting requirements.

<sup>51</sup>This third restriction is imposed by rule 27a-1. 17 C.F.R. § 270.27a-1. Certain notice requirements regarding surrender and withdrawal rights also must be observed. See Investment Company Act §§ 27(e), 27(f), 15 U.S.C. §§ 80a-27(e), -27(f).

<sup>52</sup>Under a "spread load" design, an issuer may deduct a maximum of 20% of any payment, or an average of 16% of the first 48 monthly payments, provided that the overall load does not exceed nine percent of total payments and certain other conditions are met. The periodic payment spread load should not be confused with the spread load used by some mutual funds, which consists of a rule 12b-1 fee and a contingent deferred sales load. See Chapter 8.

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death benefit if the annuitant dies before a specified time. The insurer assumes an expense risk when an annuity contract guarantees that administrative charges under the contract will not increase even if actual administrative costs increase during the life of the contract.

Risk charges are not compensation for performing bookkeeping or other administrative services under section 26(a) and therefore are prohibited. Attempts to adopt a rule to permit the deduction of these charges have been unsuccessful; consequently, a variable annuity issuer must obtain an exemptive order to deduct risk charges.<sup>53</sup>

## 2 Variable Life Insurance

When variable life insurance was first introduced in the early 1970's, the Commission decided to exempt the product from regulation under the Investment Company Act on the assumption that state insurance law would be adapted to provide protections comparable to those afforded under the Act.<sup>54</sup> Shortly thereafter, because of dissatisfaction with the state regulatory effort, the Commission adopted rule 6e-2 for certain scheduled premium variable life insurance contracts.<sup>55</sup> Rule 6e-2 seeks to accommodate the insurance elements of variable life contracts without sacrificing Investment Company Act regulation. It exempts a qualifying separate account, principal underwriter, and depositor from many sections of the Act that are inconsistent with the operation of variable life insurance.

Rule 6e-2 does not deal with the particular problems presented by flexible premium variable life insurance, a product developed in the early 1980's. In 1983, the Commission proposed rule 6e-3, which was designed to accommodate the

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<sup>53</sup>See *infra* notes 87-90 and accompanying text. Applicants for exemptive relief from sections 26(a)(2) and 27(c)(2) to deduct risk charges must represent, among other things, that the charge is within the range of industry practice for comparable contracts or reasonable in relation to the risks assumed. If an applicant anticipates that sales loads under the contract will not cover sales expenses, and consequently that proceeds of ~~risk~~ charges may be used to pay for distribution costs, the insurance company also must represent that there is a reasonable likelihood the distribution financing arrangement under the contract will benefit contract owners and the separate account.

<sup>54</sup>Inv. Co. Act Rel. 7644, *supra* note 33. The Commission was concerned particularly with uniform valuation of portfolio securities, annual reporting requirements, unauthorized changes in investment policies, excessive fees, and affiliated transactions. Id.

<sup>55</sup>"Separate Accounts of Life Insurance Companies Funding Certain Variable Life Insurance Contracts, Investment Company Act Release No. 9482 (Oct. 18, 1976), 41 FR 47023 (adopting rule 6e-2). See also Inv. Co. Act Rel. 9104, *supra* note 11 (proposing release).

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unique features of flexible premium variable life insurance contracts.<sup>56</sup> In 1984, the Commission adopted rule 6e-3(T) on a temporary basis in order to gain some experience with flexible premium variable life insurance.<sup>57</sup> The variable life insurance rules offer insurers needed relief from those provisions of the Investment Company Act that are incompatible with the operation of insurance contracts.

The main charges deducted under a typical variable life insurance contract are: (1) front-end, deferred, and/or contingent deferred sales loads; (2) administrative expense charges; (3) cost of insurance charges (the cost of death benefit protection); (4) mortality and expense risk charges; and (5) investment related charges, such as investment advisory fees. Regulation of cost of insurance is left to state law because of the insurance nature of the charges. Sales loads, administrative charges, and mortality and expense risk charges are regulated under sections 26 and 27 of the Investment Company Act. Advisory fees are subject to section 36(b) of the Act.

#### a. Sales Loads

The sales load assessed under a variable life contract is regulated by section 27 and rules 6e-2 or 6e-3(T). Each rule provides that the sales load may not exceed nine percent of total premiums paid or expected to be paid over the lesser of twenty years or the life expectancy of the insured. An insurer may comply with this provision in one of two ways. It may choose a "level" load and deduct no more than nine percent from each premium payment,<sup>58</sup> or it may use an "excess" load and deduct a percentage that exceeds nine percent of payments

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<sup>56</sup>Inv. Co. Act Rel. 13632, *supra* note 5. Flexible premium contracts permit a contract owner to vary the timing and/or amount of premium payments and to adjust the level of death benefit protection. Rule 6e-3(T)(c)(1), 6e-3(T)(d)(2), 17CFR. § 270.6e-3(T)(c)(1), .6e-3(T)(d)(2). Scheduled contracts generally require a contract owner to adhere to a premium payment plan and do not permit adjustments in the level of death benefit protection (except to the extent it varies with the investment experience of the separate account). Rule 6e-2(c)(1), 17C.F.R. § 270.6e-2(c)(1).

<sup>57</sup>Separate Accounts Funding Flexible Premium Variable Life Insurance Contracts, Investment Company Act Release No. 14234 (Nov. 14, 1984), 49 FR 47208. Rule 6e-3(T) has been amended twice since 1984. Separate Accounts Funding Flexible Premium Variable Life Insurance Contracts, Investment Company Act Release Nos. 14625 (July 10, 1985), 50 FR 28930 and 15651 (Mar. 30, 1987), 52 FR 11187.

<sup>58</sup>Rule 6e-3(T)(b)(13)(i)(B), 17C.F.R. §§ 270.6e-3(T)(b)(13)(i)(B). While there is no corresponding provision in rule 6e-2, an insurer under a scheduled premium contract may choose a level sales load in compliance with Investment Company Act sections 27(a)(1) and 27(h)(1).

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made in the early contract years but decreases in later contract years to remain within the aggregate limit.<sup>59</sup>

An excess load structure for a variable life insurance contract with scheduled premiums is easy to monitor. Premiums under a scheduled contract are paid in a predictable pattern, usually in level amounts. Because it is known what payments are expected to be made over the life of the contract, it can readily be determined whether the loads assessed will exceed nine percent of total premium payments.

An excess load structure for a flexible premium contract, on the other hand, is more difficult to monitor because the contract gives the owner the right to vary the timing and amount of premium payments. It is not possible to predict accurately the total amount of premium payments that will be made under the contract. To assure compliance with the nine percent limit, Rule 6e-3(T) uses the concept of a "guideline annual premium," which simulates a pattern of fixed payments over a specified period based on certain assumptions<sup>60</sup>.

Whether premiums are scheduled or flexible, considerable limits are imposed on the use of excess loads. For example, sales loads deducted during the first twelve contract months may never exceed fifty percent of any one payment or, for flexible contracts, one guideline annual premium. In addition, under "stair step" provisions, the proportionate amount of any sales load deducted from any payment generally may not exceed the proportionate amount deducted from any prior payment.<sup>61</sup> Finally, to the extent a variable life insurance contract has an excess load, an issuer must allow the contract owner to surrender the contract during the first twenty-four months and receive a refund of "excess" loads paid. The contract owner must get back the amount of any load in excess of thirty percent of first year payments (or of the guideline annual premium for

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<sup>59</sup>Rules 6e-2(b)(13)(i), 6e-3(T)(b)(13)(i)(A), 17 C.F.R. §§ 270.6e-2(b)(13)(i), .6e-3(T)(b)(13)(i)(A). Variable life insurers frequently use excess load designs. The use of a 20 year term enables the Commission to assure compliance with the nine percent limit for variable life contracts having an excess load design. Without the use of an artificial maximum term, the nine percent limit could be easily circumvented by an insurer through the use of an unreasonably long period over which to "average" sales load deductions.

<sup>60</sup>Rule 6e-3(T)(c)(8), 17 C.F.R. § 270.6e-3(T)(c)(8).

<sup>61</sup>Investment Company Act §§ 27(a)(3), 27(h)(3), 15 U.S.C. §§ 80a-27(a)(3), -27(h)(3); rules 6e-2(b)(13)(ii), 6e-3(T)(b)(13)(ii), 17 C.F.R. §§ 270.6e-2(b)(13)(ii), .6e-3(T)(b)(13)(ii).

<sup>62</sup>Investment Company Act section 27(d), 15 U.S.C. § 80a-27(d); rules 6e-2(b)(13)(v), 6e-3(T)(b)(13)(v), 17 C.F.R. §§ 270.6e-2(b)(13)(v), .6e-3(T)(b)(13)(v).

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flexible contracts), ten percent of second year payments (or guideline annual premium), and nine percent of any additional payments made during the twenty-four month period.

### **b. Administrative Expenses**

Rules 6e-2 and 6e-3(T) provide relief from sections 26(a)(1), 26(a)(2), and 27(c)(2) to permit the deduction of certain charges from separate account assets and to permit various custodial activities regarding those assets. Unlike variable annuities, the administrative expenses under scheduled premium variable life contracts are not limited to cost, but must be reasonable in relation to the services rendered and expenses incurred.<sup>63</sup> The fees for administrative services performed under a flexible premium contract, on the other hand, must be limited to the cost of the services provided.<sup>64</sup>

### **c. Mortality and Expense Risk Charges**

Mortality and expense risk charges under variable life insurance contracts compensate the insurer for the risk that actual mortality rates will differ from actuarial projections or that actual expenses will exceed guaranteed rates. In contrast to variable annuities, the insurer's mortality risk is the risk that the insured will die sooner than projected and thus before the expected amount of

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<sup>63</sup>Rule 6e-2(b)(13)(iii)(C), 17 C.F.R. § 270.6e-2(b)(13)(iii)(C). Despite the language of that section, the industry apparently views it as requiring that administrative expenses under a scheduled premium contract be limited to cost, similar to the requirement in rules 26a-1 and 6e-3(T) for variable annuities and flexible premium contracts, respectively. See, e.g., Letter on behalf of Prudential Ins. Co. of Am. to Jonathan G. Katz, Secretary, SEC 70, 77-78 (Oct. 2, 1990), File No. S7-11-90 [hereinafter Prudential Study Comment]. (Documents referred to in this chapter as "Study Comments" were submitted to the Commission in response to its request for comments on reform of the regulation of investment companies. Investment Company Act Release No. 17534 (June 15, 1990), 55 FR 25322.)

<sup>64</sup>Rule 6e-3(T)(b)(13)(iii)(A), 17 C.F.R. § 270.6e-3(T)(b)(13)(iii)(A). Rule 6e-2 was adopted before the Commission established the "at cost" standard in rule 26a-1 for variable annuities. When rule 6e-3(T) was later adopted, the requirements of rule 26a-1 were incorporated into that rule. The industry apparently views both forms of variable life contracts as subject to the "at cost" standard. See, e.g., Prudential Study Comment, *supra* note 63, at 70, 77-78.

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premium payments has been paid.<sup>65</sup> Variable life issuers deduct mortality and expense risk charges from separate account assets pursuant to exemptive rule.<sup>66</sup>

## 111. Problems with the Current Regulatory Framework

### A. The Nature of the Products and Sponsors

Variable insurance contracts fall within the definition of periodic payment plans because they are contracts "providing for a series of periodic payments by the holder, and representing an undivided interest in certain specified securities or in a unit or fund of securities purchased wholly or partly with the proceeds of such payments . . .".<sup>67</sup> Despite this superficial resemblance, variable contracts differ fundamentally from the periodic payment plan contemplated by Congress: in terms of the benefits contract owners receive; the services the sponsors provide; the capital structure of the sponsor companies; and the extent of state regulation. These differences highlight the inappropriateness of the current statutory framework as applied to variable insurance and provide a basis for understanding the difficulties such issuers face.

First, in terms of the benefits contract owners receive, the differences are significant enough to justify different pricing and distribution requirements.<sup>68</sup> As discussed above,<sup>69</sup> periodic payment plans are no more than a means of purchasing securities by installment. In the early stages of plan participation, an

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<sup>65</sup>In the case of the variable annuity, the insurer's mortality risk, in part, is the risk that the insured (annuitant) will live longer than projected. See *supra* Section 11.E.1.3.

<sup>66</sup>Rules 6e-2(c)(1)(iii), .6e-3(T)(b)(13)(iii)(F), 17C.F.R. §§ 270.6e-2(c)(1)(iii), .6e-3(T)(b)(13)(iii)(F). Because of the chronological development of the regulation of risk charges, the standards for deducting those charges are different under scheduled premium contracts and flexible premium contracts. Risk charges for scheduled premium contracts relying on rule 6e-2 must be disclosed in the prospectus and be at least equal to 50% of the maximum deductions stated in the prospectus and in the contract. Rule 6e-3(T) for flexible premium contracts contains this standard but also includes conditions similar to those required of variable annuity issuers in applications for exemptive orders under section 6(c) of the Act. See *supra* notes 53, 56 & 57 and accompanying text, and *infra* notes 85-90 and accompanying text. The Division anticipates that, even if the Investment Company Act is not amended, eventually all variable insurance products will be subject to the same standard for the deduction of risk charges.

<sup>67</sup>Investment Company Act § 2(a)(27), 15 U.S.C. § 80a-2(a)(27).

<sup>68</sup>For a discussion of pricing and distribution problems faced by variable life issuers, see *infra* Section III.C.

<sup>69</sup>See *supra* notes 37-42 and accompanying text.

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investor receives little more than the opportunity to pay excessive sales loads on initial payments. Because a relatively small portion of early payments is actually invested<sup>70</sup> there is the certainty of severe economic harm if payments are not continued. Variable insurance, on the other hand, offers a combination of insurance and investment in one product for which there is no obvious substitute. Variable life contracts provide immediate benefits to a contract owner in the form of full insurance protection after the first premium payment. Although a relatively high percentage of initial payments is subject to charge deductions, unlike the periodic payment plan investor, the variable life contract owner receives a real economic benefit.\* Variable annuities also typically offer benefits in the form of death benefit protection during the contract's pay-in phase and rights to select annuity pay-out options at rates established when the contract is purchased.<sup>72</sup>

Second, there are significant differences in the administrative services provided to contract owners that may warrant a more flexible approach for regulating variable contract charges. The periodic payment plan, because it is nothing more than a means of purchasing securities by installment, requires a plan trustee or sponsor to perform relatively simple administrative tasks. Therefore, the often illusory services for which such sponsors were paid out of trust assets before 1940 necessitated the restrictions of section 26(a)(2)(C)<sup>73</sup> and the at cost limits of rule 26a-1.<sup>74</sup> A variable insurance sponsor, on the other hand, provides a wider array of services in administering a variable contract. An insurer must make a significant commitment of capital to develop and maintain very elaborate systems that can handle a variety of contract features and monitor the panoply of insurance, tax, and securities law requirements that apply to the

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<sup>70</sup>See PPI REPORT, supra note 11, at 245 (observing that a periodic payment plan investor after making all scheduled first-year payments has only five to six percent of this amount invested on his or her behalf).

<sup>71</sup>In the PPI REPORT, the Commission emphasized the different benefits provided under the contracts in recommending that the front-end sales load under a periodic payment plan be abolished. *Id.* at 246-47. The Commission noted that the insured under a life insurance policy immediately receives the full measure of the contemplated death protection when the contract is purchased, "not 5 percent of it." *Id.* at 246.

<sup>72</sup>See supra Section II.E.1.c.

<sup>73</sup>Under this section, the trust may pay its sponsor only reasonable compensation for performing bookkeeping and other administrative services of a character normally performed by the trustee or custodian.

<sup>74</sup>For an explanation of the "at cost" limits of rule 26a-1, see *supra* Section II.E.1.b.

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contracts.<sup>75</sup> These services have real market value. According to one commenter, these services, even without a corresponding assumption of contract risks, are sold to other insurers in the group and pension markets.<sup>76</sup>

A third important distinction between the periodic payment plan and variable insurance relates to the capital structure of the sponsor companies. Periodic payment plan sponsors historically were thinly capitalized entities; plan sponsors made minimal capital investments, believing that very little capital was needed to enter the business.<sup>77</sup> Therefore, when trusts were "orphaned" and liquidated, a not infrequent occurrence in the pre-Investment Company Act era,<sup>78</sup> some investors did not receive the services for which they had already paid. Moreover, despite successful judgments, these investors could not recover damages from the thinly capitalized sponsors.<sup>79</sup> The Commission sought to remedy the problem of "orphaning" and the shortage of assets available for paying judgments by recommending to Congress the imposition of minimum capital requirements for plan sponsors.<sup>80</sup> Congress decided, however, to enact the more restrictive framework of sections 26 and 27. Because the average insurance company has a stronger capital base than the typical plan sponsor,<sup>81</sup> and because a separate account is an integral part of an insurance company with

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<sup>75</sup>See Letter from American Council of Life Insurance to Jonathan G. Katz, Secretary, SEC 16-29 (Oct. 10, 1990), File No. S7-11-90 [hereinafter ACLI Study Comment]. See also discussion of administrative expenses, *infra* notes 97-101 and accompanying text.

<sup>76</sup>Letter from Metropolitan Life Insurance Company to Jonathan G. Katz, Secretary, SEC 9 (Oct. 9, 1990), File No. S7-11-90 [hereinafter Metropolitan Study Comment].

<sup>77</sup>INSTALLMENT INVESTMENT PLAN STUDY, *supra* note 38, at 110-11 (noting that in 1935, the average outstanding capital stock of 22 major sponsor companies was valued at less than \$50,000).

<sup>78</sup>Trusts were "orphaned when their sponsor companies dissolved or became bankrupt, forcing the trusts to liquidate. Id. at 117.

<sup>79</sup>*Id.* at 117-18. Losses sometimes resulted from the sale of underlying securities in an unfavorable market when trust assets were liquidated, and were particularly heavy for those certificate holders who had only made a few payments from which sales load was taken.

<sup>80</sup>See In re Variable Annuity Life, 39 S.E.C. at 702 (citing INSTALLMENT INVESTMENT PLAN STUDY, *supra* note 38, at 119).

<sup>81</sup>At December 31, 1989, the aggregate capital and surplus (or net worth) of all 2,350 United States life insurance companies was \$80.6 billion, yielding a simple average capital and surplus size per company of \$34.3 million. See AMERICAN COUNCIL OF LIFE INSURANCE, 1990 LIFE INSURANCE FACT BOOK, at 79, 81, 105 (1990).

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little chance of being "orphaned,"<sup>82</sup> a less paternalistic structure for variable insurance regulation may be more suitable. The greater likelihood that a variable insurance contract owner would recover against an insurance company sponsor suggests that greater regulatory flexibility should be accorded such issuers.

Finally, the presence of state insurance law as an additional layer of regulation for the insurance industry distinguishes variable insurance from periodic payment plans and argues in favor of a more flexible approach for regulating variable contract charges. Before 1940, periodic payment plans were largely unregulated; therefore, the restrictive framework of sections 26 and 27 of the Act was justified, particularly in light of the abuses then existing in that industry.<sup>83</sup> Variable insurance, on the other hand, is subject to state solvency law, including the maintenance of minimum capital, statutory reserves, and investment restrictions.<sup>84</sup> Together these requirements have made the average insurance company a stronger financial entity than the typical plan sponsor. In addition, state law provides valuable protection to contract owners in the form of nonforfeiture benefits and, through the mandatory approval of contract forms before they are sold to the public, state officials ensure that every contract contains other important protections. While the Division does not recommend a full exemption from Investment Company Act regulation for variable insurance issuers, the presence of state insurance law suggests that a more flexible approach to charge regulation would be appropriate.

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<sup>82</sup>It is unlikely for a separate account to be "orphaned" because: (1) state approval is necessary before contractual obligations may be assigned in the ordinary course of business (*see, e.g.*, N.Y. INS. LAW § 1308(f)(2) (McKinney 1985 & Supp. 1990), ILL. ANN. STAT. CH. 73, § 786 (Smith-Hurd 1965 & Supp. 1990) (consent of state commissioner required for reinsurance of separate account obligations)); and (2) the states generally intervene to protect the contract owners of a troubled insurer, for example, through the use of state guaranty funds (*see, e.g.*, N.Y. INS. LAW §§ 7701-7718 (McKinney Supp. 1991); CAL. INS. CODE § 1067 (West Supp. 1991); ILL. ANN. STAT. CH. 73 § 1065.80-1 (Smith-Hurd Supp. 1991)) or through rehabilitation proceedings (*see, e.g.*, Susan Pulliam, *New Jersey Takes Over Mutual Benefit In Largest Seizure Ever of an Insurer*, WALL ST. J., July 16, 1991, at A4, col.1).

<sup>83</sup>See *supra* notes 3742 and accompanying text.

<sup>84</sup>In declaring that state insurance law did not provide adequate protection to an investor in a mutual fund, Justice Brennan in his concurring opinion in *VALIC* appeared to focus on the absence of disclosure requirements in state law. *VALIC*, 359 U.S. at 78, 85-86 (Brennan, J., concurring). The Division believes that state law affords protections similar to those currently provided by sections 26 and 27 of the Investment Company Act. *See infra* notes 138,140-143 and accompanying text.

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## B. The Investment Charge - Insurance Charge Dilemma

Regulation of variable products under the system established for periodic payment plans presents a formidable challenge: the Commission must enforce the rigid controls placed on charges levied by the plans, and, at the same time, attempt to separate the insurance features of variable contracts from their investment features and regulate only the latter. Efforts to regulate some charges, but not others, may be ineffectual because issuers may compensate for restrictions on regulated charges by increasing unregulated charges and using the proceeds for regulated purposes. These problems argue in favor of a regulatory approach that explicitly grants the Commission jurisdiction over all contract charges.

The Commission's experience with mortality and expense risk charges is illustrative. The insurance industry contends that mortality and expense risk charges are insurance charges properly subject to state regulation and outside the Commission's jurisdiction.<sup>85</sup> The Commission, on the other hand, is concerned that an insurer may use the proceeds of mortality and expense risk charges to pay for distribution, an activity that is properly within the Commission's domain. In fact, mortality and expense risk charges may be used to cover insurance-related expenses or may be profit, depending upon the ultimate wisdom of the actuarial projections that shape the contract. If the actual mortality and expense experience under a contract is consistent with or better than the original projections of the pricing actuary, the insurer makes a profit on the charge. If actual experience differs and mortality or expense losses exceed original projections, the risk charge is needed to pay "insurance" costs. Many insurers anticipate, however, that the entire risk charge deduction will not be needed to pay contingent mortality costs or administrative expenses under the contracts.<sup>86</sup>

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<sup>85</sup> The industry always has asserted that the Commission's jurisdiction over variable insurance contracts extends only to their investment element, with the states retaining exclusive authority to regulate the insurance aspect of the contracts. See, e.g., Letter from American Council of Life Insurance to Jonathan G. Katz, Secretary, SEC **12-13** (June 5, 1987), File No. **S7-6-87** [hereinafter ACLI Reproposal Comment] (discussing repropoosed rule 26a-3). See also *infra* note **88** and accompanying text.

<sup>86</sup> See, e.g., IDS Life Ins. Co., Investment Company Act Release Nos. **18221** (July 3, 1991), **56 FR 31452** (Notice of Application) and **18252** (July 31, 1991), **49** SEC Docket **0761** (Order); Allstate Life Ins. Co. of New York, Investment Company Act Release Nos. **17640** (Aug. 1, 1990), **55 FR 32524** (Notice of Application) and **17709** (Aug. 29, 1990), **46** SEC Docket **1985** (Order); NN Investors Life Ins. Co., Investment Company Act Release Nos. **17364** (Mar. 5, 1990), **55 FR 9239** (Notice of Application) and **17405** (Apr. 3, 1990), **45** SEC Docket **1787** (Order) (all stating that the insurer expects to profit from the mortality and expense risk charge).

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Beginning in 1980, the Commission interpreted the Investment Company Act to require insurers to obtain exemptions from sections 26(a)(2) and 27(c)(2) to deduct the so-called risk charges from the assets of the separate account.<sup>87</sup> The volume of these applications led to proposed rule 26a-3, proposed in 1984 and repropored in 1987 but never adopted.<sup>88</sup> The arguments over the rule consistently have been drawn along jurisdictional lines: the industry claims the Commission does not adequately acknowledge the insurance nature of the charges, and the Commission seeks to limit risk charges so that the charges cannot be used as a hidden funding vehicle for distribution expenses.<sup>89</sup> In the mid-1980's, the Division took the position that it would **not support** exemptions from the Act for risk charges that exceeded specified levels.<sup>90</sup> The Division's search for an appropriate standard for mortality and expense **risk** charges was suspended when the Investment Company Act Study began.

### C. Problems With Variable Life Insurance -- Industry Concerns

The insurance industry claims that the application of sections 26 and 27 of the Investment Company Act to variable life insurance has created enormous pricing and distribution problems for insurers. Under current regulation, an insurer may not price its contracts in a way that adequately reflects the heavy capital expenditure needed to establish and maintain a variable insurance operation. In addition, an insurer may not distribute its variable life contracts on

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<sup>87</sup>See, e.g., Beneficial Nat'l Life Ins. Co., Investment Company Act Release Nos. **11101** (Mar. 25, 1980), **45 FR 21417** (Notice of Application) and **11173** (May 19, 1980), 20 SEC Docket **77** (Order). Management separate accounts also obtained exemptions from Investment Company Act section 12(b) (15 U.S.C. § 80a-12(b)), if the accounts expected to pay part of their distribution expenses with the proceeds of risk charges. See, e.g., Travelers Ins. Co., Investment Company Act Release Nos. **13130** (Mar. 31, 1983), **48 FR 15059** (Notice of Application) and **13241** (May 13, 1983), 27 SEC Docket **1668** (Order).

<sup>88</sup>Exemptive Relief for Variable Annuity Separate Accounts Relating to Deduction of Certain Charges from Account Assets, Investment Company Act Release Nos. **14190** (Oct. 11, 1984), **49 FR 40879** (proposal) and **15586** (Feb. 26, 1987), **52 FR 7166** (reproposal). When comments received in response to the reproposal suggested that few registrants would be able to meet the proposed standards, the Division began to consider a third version.

<sup>89</sup>For a general discussion of the history of risk charges, see ACLI Reproposal Comment, supra note **85**.

<sup>90</sup>After an informal survey of industry practice, the Division decided that applications for the deduction of risk charges would not be processed under delegated authority if they exceeded **1.25%** for a variable annuity contract, **0.50%** for a scheduled premium variable life contract, and **0.90%** for a flexible premium variable life contract. The Division has advised insurance companies that it would recommend that such applications be set down for a Commission hearing.

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an equal basis with fixed-dollar contracts unless it undertakes an extra burden on its capital and surplus. Accordingly, variable life insurance has had modest growth, both in terms of product development and in terms of the number of insurers offering the product.

Many commenters asserted that the current statutory emphasis on regulation of individual charges is inappropriate for variable insurance because it inhibits product development.” While the structure may work for periodic payment plans, the economics of life insurance demands greater flexibility.<sup>92</sup> In designing a new contract, an actuary must make important assumptions regarding a number of pricing variables.<sup>93</sup> In seeking to establish an appropriate contract price, the actuary strives for the optimum combination of assumptions that, consistent with company objectives, would enable the company to recover its expenses on a block of policies within a given number of years and then become profitable.<sup>94</sup> State law gives an insurer the flexibility it needs to adjust the pricing elements in designing new contracts. Investment Company Act

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<sup>91</sup>See, e.g., Prudential Study Comment, *supra* note 63, at 80 (the regulatory focus on each separate charge is unworkable and interferes with the design and proper pricing of variable life contracts); Letter from Equitable Life Assurance Company of the United States to Jonathan G. Katz, Secretary, SEC 6 (Oct. 5, 1990), File No. S7-11-90 (stating that regulation under sections 26 and 27 has constrained product design and innovation); Metropolitan Study Comment, *supra* note 76, at 8 (stating that the periodic payment plan constraints, as applied to variable insurance, have restricted the depth of innovation).

<sup>92</sup>The business of life insurance requires an insurer to finance the heavy costs of issuing a policy. These costs include sales commissions, advertising costs, underwriting expenses, and first-year administrative expenses, and may constitute as much as 110% of first-year premium payments. DAN M. MCGILL, LIFE INSURANCE, 253-54 (rev. ed. 1967). To be affordable, life insurance usually is paid for over many years. The first-year premium is usually insufficient to pay for issuance expenses, death claims occurring during the year (cost of insurance charges) and to meet statutory reserve requirements. Therefore, a company relies on its capital and surplus to finance these obligations, hoping to recover these amounts from continuing contract payments remitted over the years. For a discussion of the economics of life insurance, see generally KENNETH BLACK, JR. & HAROLD SKIPPER, JR., LIFE INSURANCE 23,350-351 (11th ed. 1987).

<sup>93</sup>In pricing a life insurance policy, an actuary must make critical judgments concerning six basic elements for a block of policies: (1) the probable rate of death and, therefore, payment of claims; (2) expected earnings on investment of premium payments; (3) long-term expenses of administering the policy; (4) the rate of persistency (*i.e.*, the probability that the contract would not lapse or be terminated before the company has recovered the expenses incurred in issuing the policy); (5) an expected profit margin that accords with company objectives; and (6) contingencies (a factor to allow for unexpected events). See BLACK & SKIPPER, *supra* note 92, at 16, 367.

<sup>94</sup>Depending on a company’s philosophy or the extent of new business it has issued, a company expects to recover its expenses over a period of years that generally may range from five to twelve years. *Id.* at 369.

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regulation, by contrast, limits almost all pricing elements and thus inhibits the actuarial process.

By restricting individual contract charges, current Investment Company Act regulation forces the creation of inappropriately priced contracts. An insurer may not arrive at the combination of assumptions that best suits its objectives and that may produce the best value for contract owners.<sup>95</sup> In addition, the industry has indicated that it is difficult for companies to adapt existing fixed-dollar contract designs to a variable contract form because of the restrictions of sections 26 and 27.<sup>96</sup> These sections, which are more restrictive than state law, cause an insurer to make costly changes to its administrative systems in reproducing fixed-dollar designs.

The lack of pricing flexibility in variable life insurance is exacerbated by the stringent limits placed on specific charges. In particular, most commenters were critical of the requirement that an insurer must perform the administrative services under a variable life contract at cost.<sup>97</sup> Unlike periodic payment plans where sponsors incur very little capital expenses,<sup>98</sup> the operation of variable life insurance requires a heavy capital outlay.<sup>99</sup> An insurer must develop elaborate

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<sup>95</sup>The benefit of greater pricing flexibility to contract owners was well illustrated by one commenter who demonstrated that, with greater pricing flexibility, it could design a variable life contract that produces higher cash surrender values for contract owners. Prudential Study Comment, *supra* note 63, at 89-99.

<sup>96</sup>See ACLI Study Comment, *supra* note 75, at 8 (charge structures typical of more traditional, fixed-dollar insurance products are difficult to replicate for variable contracts).

<sup>97</sup>See, e.g., Prudential Study Comment, *supra* note 63, at 102-03 (because of extensive administrative services, "compensation" should include a fair, reasonable profit); Metropolitan Study Comment, *supra* note 76, at 9 (insurance company should be able to make a profit on its charges for the significant administrative services it provides); Letter from Los Angeles County Bar Association, Business & Corporations Law Section, to Jonathan G. Katz, Secretary, SEC 5 (Oct. 9, 1989) [sic], File No. S7-11-90 [hereinafter LA Bar Study Comment] (administrative charges should not be limited to "cost," but should be left to free market competition).

<sup>98</sup>See *supra* notes 73-77 and accompanying text.

<sup>99</sup>See, e.g., ACLI Study Comment, *supra* note 75, at 16-29. The Equitable Variable Life Insurance Company spent approximately Seven and one-half million dollars before selling its first policy in the late 1970s, and North American Reassurance Company is estimated to have spent eight to nine million dollars developing a variable life service-reinsurance package. RICHARD JOHNS, VARIABLE LIFE INSURANCE - AN OUTSIDE VIEW, 25-26 (1977).

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administrative systems to handle the far more complex variable life contract.”<sup>101</sup> In addition, such systems must be capable of monitoring compliance with a variety of securities, insurance, and tax law provisions.<sup>101</sup> An insurer would not be willing to invest heavily in variable life insurance if it perceived any competitive disadvantage in doing so. The more liberal state law pricing provisions that apply to fixed-dollar life insurance create such a disadvantage. Therefore, unless Investment Company Act regulation provides comparable flexibility to issuers of variable life insurance, many insurers would continue to emphasize fixed-dollar products.

Another major concern expressed by commenters was the belief that the refund requirements of section 27(d) and rules 6e-2 and 6e-3(T) create a marketing bias against the sale of variable life insurance.<sup>102</sup> Under these provisions, an insurer is required to return (or may not deduct more than) certain prescribed sales load amounts if an excess-loaded contract is surrendered during the first twenty-four contract months.<sup>103</sup> Some commenters asserted that, compared with fixed life insurance, these requirements are too onerous because they force companies that must pay competitive commissions for selling variable life insurance to bear an additional strain on the companies' capital and surplus.<sup>104</sup> Many insurers appear unwilling to commit significant amounts of capital to

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<sup>100</sup>The typical variable life contract contains a variety of features such as different premium payment options, varying methods of expense deductions, cash surrender values that may change daily, different investment options (*e.g.*, money market, aggressive growth, bond subaccounts), different death benefit options, exchange privileges among investment options, withdrawal rights, tax-deferred benefits, and varying riders providing for optional benefits. See generally ACLI Study Comment, *supra* note 75, at 19-20.

<sup>101</sup>*Id.* at 21-29.

<sup>102</sup>See, *e.g.*, *id.* at 14-16; Metropolitan Study Comment, *supra* note 76, at 8-9.

<sup>103</sup>Rules 6e-2(b)(13)(v), 6e-3(T)(b)(13)(v), 17 C.F.R. §§ 270.6e-2(b)(13)(v), .6e-3(T)(b)(13)(v). For further discussion of these provisions, see text accompanying note 62 *supra*. Insurance companies traditionally have paid high front-end commissions for selling life insurance and have financed these amounts from capital and surplus because of the insufficiency of first-year premiums. BLACK & SKIPPER, *supra* note 92, at 527,350-51. The Commission has acknowledged the need for paying high commissions in early contract years. PPI REPORT, *supra* note 11, at 246. A company expects to recover these expenses when premiums are paid in subsequent years. If a contract is terminated before the expected recovery period, the insurance company incurs a loss unless the proceeds of surrender are sufficient to cover unamortized expenses and to the extent state or federal law permits the insurer to deduct these expenses.

<sup>104</sup>One company indicated that the refund provisions of rules 6e-2 and 6e-3(T) can delay recovery of its issuance costs for up to six years compared to fixed products. Metropolitan Study Comment, *supra* note 76, at 8.

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establish and maintain a variable life operation if they cannot sell such contracts on an equal basis with fixed-dollar products.

The effect of the refund requirements on a variable life issuer's capital and surplus may be best illustrated by example. Assume that an insurer pays an agent that sells a scheduled premium variable life contract a commission equal to fifty-five percent of the first year annual premium, the same rate it pays for selling a comparable fixed-dollar life contract. Consistent with industry practice, the insurer finances a portion of this commission, together with other issuance expenses, from its capital and surplus. If the contract is surrendered after six months, the insurer may assess a sales load of only thirty percent of the first year annual premium.<sup>105</sup> The company, therefore, will incur a loss of twenty-five percent on the contract, unless it can recapture commissions from the selling agent, a difficult task to accomplish. Under a fixed-dollar contract, by contrast, an insurer may recover a higher portion of its unamortized issuance expenses because of the more liberal state refund (nonforfeiture) requirements. To minimize its loss, the variable life issuer can pursue one of two basic courses. First, it can establish a higher annual premium and, by applying a lower commission rate, effectively pay the agent the same amount that is paid for selling the fixed-dollar contract; alternatively, it can pay the agent a commission equal to the effective current maximum limit of thirty percent. Under either option, however, the variable life issuer would be at a competitive disadvantage. Because the fixed-dollar contract is a close substitute for the variable life contract, the two contracts must have reasonably competitive prices. In addition, an agent would not have an incentive to sell a variable life contract paying a commission of thirty percent when that agent can earn a higher commission for selling a comparable fixed-dollar contract.

The net effect of current pricing and distribution problems has been to make the offering of variable life insurance riskier than the sale of fixed-dollar contracts.<sup>106</sup> Not many insurers appear willing to undertake additional risk of offering variable life insurance, particularly when they can sell certain interest-

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<sup>105</sup>See rule 6e-2(b)(13)(v), 17 C.F.R. § 270.6e-2(b)(13)(v). Instead of deducting a 30% sales load upon surrender, an insurer may deduct a 50% load when the premium is paid and return 20% to the contract owner at the time of surrender. See Investment Company Act § 27(a)(2), 15 U.S.C. § 80a-27(a)(2) (issuer may deduct up to 50% of any of the first 12 monthly payments). The effective load in either case is 30% for surrenders made during the first contract year.

<sup>106</sup>Metropolitan Study Comment, *supa* note 76, at 8 (current refund restriction can have a significant impact on the profitability of a variable product and increase the risk to the insurance company).

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sensitive, fixed-dollar life contracts<sup>107</sup> that are relatively close substitutes for variable life insurance and avoid regulation under the federal securities laws. As a result, variable life insurance has not realized its growth potential. The few insurers that have entered the marketplace are the larger companies that have a strong capital base capable of withstanding the additional strain on their capital and surplus, and smaller insurers that are committed to the product.

#### D. Problems with Variable Annuities -- How Much Is the "Insurance" Worth?

Related to the problem of the uses to which the proceeds of risk charges may be applied<sup>108</sup> is the question of the extent to which there exists a justifiable basis for deducting mortality and expense risk charges during a variable annuity's pay-in phase. Insurers assert that it is appropriate to deduct risk charges because the variable annuity offers important insurance benefits: annuity options at pre-established rates, death benefit protection during the pay-in phase, and expense guarantees. In support of this assertion, insurers make representations regarding the reasonableness of risk charges.<sup>109</sup> However, the Division has had a difficult time in determining whether and to what extent these insurance benefits contain value.

While variable life insurance must contain a significant insurance element,<sup>110</sup> there is no comparable requirement for variable annuities. Unlike variable life insurance, a purchaser of a variable annuity need not provide evidence of insurability before his or her application for a contract is approved.<sup>111</sup> There is no evidence that the annuity purchase rates guaranteed when the contract is purchased are significantly more advantageous than rates a

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<sup>107</sup>Interest sensitive fixed-dollar life contracts refer to insurance policies developed within the last 15 years that permit an owner to share more meaningfully in the investment returns (and other operating efficiencies) of the insurance company. They may be distinguished from the traditional whole life insurance contract, under which insurers historically have credited a conservative interest rate (usually from two and one-half to four percent) on cash value accumulation and have not adjusted other pricing assumptions to reflect favorable operating experience. See BLACK & SKIPPER, *supra* note 92, at 28, 71.

<sup>108</sup>See discussion in Section III.B., *supra*.

<sup>109</sup>See *supra* note 53 and accompanying text.

<sup>110</sup>See *supra* note 18.

<sup>111</sup>Before deciding whether to issue a variable life insurance contract, an insurer, in a process called medical underwriting, usually assesses the insured's risk based on factors such as age, sex, and health.

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mutual fund investor could find if he or she decided to purchase an annuity with his or her accumulated investment in a regular mutual fund.<sup>112</sup> It is also questionable whether expertly priced expense guarantees expose an insurer to any meaningful risk. Finally, the minimum death benefit which typically guarantees the return of premium payments, arguably protects against a relatively small risk.

For these reasons, the Division has considered whether variable annuity issuers should have as much pricing flexibility as issuers of variable life contracts to deduct "insurance-related" charges. The inquiry is particularly relevant since the expenses of issuing a ~~contract appear~~ to be lower than the expenses incurred in selling a variable life contract,<sup>113</sup> and because the marketing strategies of most variable annuity issuers appear to focus on the contract's tax-deferral and investment features rather than insurance benefits.<sup>114</sup> In many respects, the variable annuity separate account operates much like a mutual fund during the contract's pay-in phase. As a result, the Division and other commenters have questioned whether variable annuity issuers should be permitted to deduct asset-based charges (like risk charges) on a basis that is different from that required of mutual funds.<sup>115</sup>

Notwithstanding the questionable worth of a variable annuity's insurance benefits, the Division believes that the contract does offer some insurance protection, and that an issuer should be permitted to assess a reasonable fee for

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<sup>112</sup>If information about the number of contract owners that annuitize were available, perhaps it would be easier to determine the meaningfulness of annuity purchase rate guarantees and to gauge the reasonableness of mortality and expense **risk** charges. However, variable annuity issuers claim that statistics on the percentage of contract owners that annuitize are not available, and, in any event, would not be very useful at this time because the industry may not have been in existence long enough to produce meaningful trends.

<sup>113</sup>The Division is aware of only one issuer that offers an excess-loaded variable annuity contract. All other issuers assess sales loads that are comparable with those paid under mutual funds.

<sup>114</sup>If enacted, a recent Treasury Department proposal would eliminate the tax-deferred feature of variable annuities unless the contract contains a life contingency. Pension annuities and annuities that are part of structured settlements are excluded from the proposal. See Ellen E. Schultz, *Insurers Attack Bush Proposal on Annuities*, WALL ST. J., Jan. 31, 1992, at C1, col.3; Ellen E. Schultz, *Annuities: Treasury's Switch May Spur Buying*, WALL ST. J., Feb. 3, 1992, at C1, col. 3.

<sup>115</sup>See Executive Summary, Letter of Investment Company Institute to Jonathan G. Katz, Secretary, SEC 10-11 (Sept. 19, 1988), File No. S7-10-88 (responding to Payment of Asset-Based Sales Loads by Registered Open-End Management Investment Companies, Investment Company Act Release No. 16431 (June 8, 1988), 53 FR 23258) (claiming competitive disadvantage to mutual funds in relation to variable insurance products because of different treatment of rule 12b-1 fees and risk charges).

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underwriting these risks. Accordingly, the Division does not recommend prohibiting such charges. At the same time, the Division does not believe the Commission should continue to expend resources in trying to affix a reasonable value to mortality and expense risk charges individually; rather, any attempt to assess the reasonableness of risk charges should be part of a larger effort to determine the overall reasonableness of aggregate interest charges. The history of the rulemaking effort for rule 26a-3<sup>116</sup> illustrates the futility of retaining an individualized approach to charge regulation, under which limits are established for investment-related charges but not for insurance-related charges. The aggregate approach to charge regulation the Division is recommending would improve the Commission's role in regulating variable contracts and avoid most of the regulatory problems we have identified.

## IV. Recommendation

The Division believes that variable insurance issuers should have the same ability as mutual funds to set product charges as long as the charges are plainly disclosed and not excessive.<sup>117</sup> Accordingly, the Division recommends that the Commission propose amendments to the Investment Company Act to exempt variable insurance contracts from the charge restrictions in sections 26 and 27, and instead require aggregate charges under variable contracts to be reasonable.<sup>118</sup> Under the Division's proposal, the Commission would be given explicit authority to adopt rules establishing guidelines for this standard.

The Division's proposal would eliminate most of the current charge limits for variable contract issuers:

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<sup>116</sup>See *supra* notes 88-89 and accompanying text.

<sup>117</sup>Mutual funds are not subject to any numerical limits on charges under the Act, except in a few minor instances. See, e.g., Investment Company Act §§ 10(d)(4), 10(d)(6), 15 U.S.C. §§ 80a-10(d)(4), -10(d)(6) (setting forth limits on certain charges for certain investment companies). The focus of regulation is the prevention of excessive charges while giving fund management appropriate business flexibility. Thus, for example, section 22(b) prohibits excessive sales loads and section 36(b) prohibits excessive charges by imposing a fiduciary duty on certain recipients of payments for investment advisory services.

<sup>118</sup>The Division does not recommend that the Commission use its rulemaking authority to resolve these regulatory problems. While the Commission could adopt rules to provide for the deduction of risk charges, relax the refund requirements, or repeal the "at cost" standard for administrative expenses, the Division believes that these actions would provide unsatisfactory remedies. Adopting rules under current statutory provisions would perpetuate the basic regulatory and jurisdictional problems the Commission has experienced over the years.

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- o There would be no direct limit on the amount of administrative charges under a variable insurance contract. Rather, administrative charges would be regulated as a component of aggregate charges.
  - o Insurance-related charges, such as mortality and expense risk charges and cost of insurance, would be subject to the federal securities laws as components of aggregate charges. **Risk** charges would no longer be subject to *de facto* limits.<sup>119</sup>
  - o The limits of section 27 would not apply to sales charges, but sales charges would be subject to the reasonableness requirement for aggregate charges and any guidelines established by Commission rules. There would be no refund, conversion, or free-look requirements under the Investment Company Act, although state law typically provides similar provisions. There would be no "stair step" requirements.
  - o Variable annuity sales charges would still be subject to section 22(b) and NASD rules.<sup>120</sup> Although there are no current NASD limits pertaining to variable life insurance sales charges, the Commission and NASD would retain authority under section 22(b) to promulgate standards for sales loads under those contracts.

In conjunction with the proposed increased flexibility in pricing, the Division expects to give priority to the development of a registration form for variable life insurance and standardized illustrations of benefits and expenses for variable insurance contracts to be used in prospectuses and supplemental sales literature. Improved disclosure would foster competition, particularly in variable life insurance, because it would assist contract owners in comparing the relative costs and benefits of competitive contracts.

#### A. Statutory Amendments

As described more fully below, under the Division's proposal, section 26 would be amended in three ways.<sup>121</sup> New paragraph (a)(5) would exempt a

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<sup>119</sup>See *supra* note 90.

<sup>120</sup>See, e.g., NASD RULES, *supra* note 48, at Art. III, § 29(c) (limits the front-end sales load on variable annuities to eight and one-half percent of total payments, determined over a maximum period of 12 years).

<sup>121</sup>The proposed text of the amendments appears at the end of this chapter in Appendix 10-A.

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registered separate account, its sponsor, and its principal underwriter from the requirements of section 26(a). New subsection (e)(1) would establish a reasonableness standard for evaluating total contract charges, require insurers to represent that such charges are reasonable, and also explicitly would authorize the Commission to adopt rules for determining when contract charges may be reasonable. Subsection (e)(2) would codify the existing custodial and capital requirements set forth in the variable insurance rules.

Section 27 would be amended in two ways. A new subsection (i) would exempt a registered separate account, its sponsor, and its principal underwriter from the requirements of section 27, except for new subsection 27(j). Subsection 27(j) would require registered separate accounts organized as management companies to comply with all the provisions of proposed section 26(e).

### **1. The Reasonableness Standard -- Section 26(e)(1)**

Proposed section 26(e)(1) would require the total charges under a variable insurance contract to meet a reasonableness standard: an issuer would be required to establish aggregate charges that are reasonable in relation to the services rendered under the contract, the expenses expected to be incurred, and the risks assumed by the insurance company.<sup>122</sup> Under this standard, an insurer could consider all relevant factors in assessing the reasonableness of contract charges. For example, an insurance company could take into account the nature and extent of services performed under a variable insurance contract, the benefits conferred on the contract owner, and the nature and extent of the risks assumed by the insurer. The standard also contemplates that a reasonable profit could be built into the price of a variable insurance contract.

The Division believes that the reasonableness standard, together with Commission rulemaking authority, would improve regulation of variable insurance under the Investment Company Act. The proposal provides a fair measure for contract charges. At the same time, the reasonableness standard gives the insurance industry the business flexibility it needs to develop and market the products effectively.

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<sup>122</sup>The ACLI recommended a similar approach to the regulation of variable insurance charges. Under the ACLI's proposal, an insurer would include in its registration statement one of two representations regarding the reasonableness of aggregate contract charges as a condition for exemption from sections 26 and 27 of the Investment Company Act. ACLI Study Comment,*supra* note 75, at 10-12. The ACLI would not require explicitly that charges be reasonable, however. The ACLI proposal also differs from the Division's in that the ACLI would not give the Commission rulemaking authority.

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A reasonableness standard to regulate contract charges is currently used under the Investment Company Act and is, therefore, not novel under the Division's recommendation. For example, to secure an exemption from sections 26 and 27 to deduct mortality and expense risk charges, insurers represent either that the charges are reasonable in relation to the risks assumed under the contracts or that the charges are reasonable because they are within the range of industry practice for comparable contracts.<sup>123</sup> Although the language of section 26(a) has been construed narrowly by the Commission, that section merely provides that payments to the trustee or custodian of a UIT be reasonable as determined by the Commission. Also, under sections 27(a)(5) and 27(a)(6), the Commission may determine the reasonableness of certain charges under periodic payment plans.

Proposed section 26(e)(1) would place the burden of assessing the reasonableness of charges on variable insurance issuers rather than the Commission. The standard contemplates a facts and circumstances analysis of each case and may require difficult determinations. As discussed below, however, the Division believes that the use of standardized hypothetical illustrations would help in evaluating the reasonableness of variable contract charges.<sup>124</sup>

The reasonableness standard the Division proposes should approximate the standard for regulation of mutual fund sales charges contained in section 22(b).<sup>125</sup> In amending section 22(b) in 1970, Congress indicated that the NASD, pursuant to its authority under this section, should give fair consideration to the interests of both sellers and investors in promulgating rules to prevent excessive sales loads.<sup>126</sup> Congress further advised the NASD to consider the nature and quality of services necessary to ensure proper distribution of fund shares to the

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<sup>123</sup>See *supra* note 53. Under the Division's proposal, the "within the range of industry practice" representation would not provide a separate basis for assessing the reasonableness of variable contract charges. It would merely be one factor to be considered in determining whether the standard has been met in a particular case.

<sup>124</sup>A discussion of hypothetical illustrations appears *infra* at notes 134-137 and accompanying text.

<sup>125</sup>Investment Company Act § 22(b), 15 U.S.C. § 80a-22(b). This section generally authorizes the NASD or other registered securities association to adopt rules that prohibit its members from assessing excessive sales loads in connection with the distribution of redeemable securities.

<sup>126</sup>Congress advised the NASD to allow for "reasonable compensation for sales personnel; for reasonable opportunity for profit for broker-dealers, and underwriters; and for reasonable sales loads to investors." HOUSE COMM. ON INTERSTATE AND FOREIGN COMMERCE, INVESTMENT COMPANY AMENDMENTS ACT OF 1970, H.R. REP. NO. 1382, 91st Cong., 2d Sess. 29 (1970).

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public, and specifically acknowledged that the rules adopted pursuant to section 22(b) might include provisions for higher sales loads in situations where relatively more selling effort is required.<sup>127</sup> Similarly, the Division's proposal would require an issuer to evaluate the reasonableness of aggregate charges by considering, among other things, the nature and quality of services provided.<sup>128</sup> The reasonableness standard is also flexible enough to allow higher charges to be deducted in cases where an insurance company takes on greater risks.

## **2. Commission Rulemaking Authority - Section 26(e)(1)**

Proposed section 26(e)(1) also would grant the Commission the authority to adopt rules and regulations that provide guidelines for determining the reasonableness of variable contract charges. The scope of the Commission's rulemaking authority would be comparable to the scope of rulemaking authority granted to the Commission under other provisions of the Investment Company Act.<sup>129</sup>

The rulemaking authority proposed by the Commission in section 26(e)(1) would balance the pricing flexibility granted to insurers by the exemptions from sections 26 and 27 of the Investment Company Act. The existence of this authority should tend to discourage excessive pricing in the variable insurance industry. While the Division does not expect that the Commission necessarily will need to use its rulemaking authority, it would be shortsighted not to acknowledge the possibility that industry practices could be subject to abuse. In the event widespread, undesirable pricing practices develop, the Commission's ability to address them should not be limited to enforcement actions for specific abuses. Rather, the Commission should have the discretion to develop appropriate regulations to the extent needed to curb industry-wide problems.

There are many factors relating to the reasonableness of contract charges that the Commission may want to consider if it became necessary to exercise its rulemaking authority under the proposal. Among these would be general economic factors and industry trends, including product development, marketing practices, and contract design. Sources of information necessary to evaluate these

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<sup>127</sup>*Id.* at 29-30. Similarly, section 27(b) permits the Commission to relax sales load limits for smaller companies that incur relatively higher operating costs in issuing periodic payment plans.

<sup>128</sup>There is a major distinction between section 22(b) and proposed section 26(e)(1) in that section 26(e)(1) would require the issuer, rather than the NASD, to make the reasonableness determination. Nevertheless, the Division believes that the comparison between the two sections is valid because of the similarity in the reasonableness standard under both sections.

<sup>129</sup>See, e.g., Investment Company Act §§ 22(c), 27(d), 15 U.S.C. §§ 80a-22(c), -27(d).

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factors might include the model rules and regulations of the National Association of Insurance Commissioners. It may be appropriate to conduct an industry-wide survey of industry practice, or commission a study similar to that done for the NASD prior to its rulemaking effort relating to sales load limits under section 22(b).<sup>130</sup> Such a study may be conducted, for example, to determine the percentage of contract owners that actually purchases annuities under guaranteed rates, a statistic that may be important in determining the reasonableness of charges for variable annuities. Under certain circumstances, it may be appropriate for the Commission to employ actuarial resources in developing rules under this provision.

### **3. Custodial Provision -- Section 26(e)(2)**

Proposed section 26(e)(2) would codify those parts of rules 26a-2, 6e-2, and 6e-3(T) that permit an insurance company to maintain custody of separate account assets,<sup>131</sup> and therefore would not change current regulation of insurance companies or their separate account operations. The codification is necessary to preserve the current custodial provisions in conjunction with the exemption provided by proposed section 26(a)(5).<sup>132</sup>

As is the case now, an insurer will be required to file with its domiciliary state an annual statement of financial condition that shows it has a combined capital and surplus (if a stock company) or an unassigned surplus (if a mutual company) of not less than \$1,000,000. The company would have to be examined periodically by state officials as to its financial condition and other affairs. In

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<sup>130</sup>See 3 BOOZ, ALLEN & HAMILTON, INC., ECONOMIC STUDY OF THE DISTRIBUTION OF MUTUAL FUNDS AND VARIABLE ANNUITIES XIV-11 (May 1972)[hereinafter BOOZ, ALLEN & HAMILTON, INC.] (prepared for the purpose of developing guidelines to assist the NASD in formulating sales load rules for investment companies in accordance with the requirements of section 22(b)).

<sup>131</sup>The Commission adopted rules to enable insurance companies to hold separate account assets without a trust indenture for two primary reasons. First, section 26(a), which requires bank custody, conflicts with state laws that prohibit an insurer from holding separate account assets in trust. Second, state insurance laws governing the safekeeping of insurance company assets generally are adequate to ensure the preservation of these assets. See Exemptive Relief for Separate Accounts Relating to Custodianship of and Deduction of Certain Fees and Charges from the Account's Assets, Investment Company Act Release No. 13706 (Jan. 6, 1984), 49 FR 1737 (proposing rule 26a-2); rules 6e-2(b)(9)(ii), 6e-3(T)(b)(9)(ii).

<sup>132</sup>Without proposed section 26(e)(2), there would be no custodial requirements under the Division's proposal for separate accounts organized as UITs. Because of the importance of custody in Investment Company Act regulation, the Division found it necessary to maintain current requirements. The provisions of sections 26(e)(2) would apply to managed separate accounts through the requirements of proposed section 27(j).

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addition, the company's separate account operations would have to be supervised and inspected by the state.

#### **4. Exemption from Sales Load Restrictions -- Sections 27(i) and (j)**

A broad exemption from the charge restrictions of section 27 is set forth in new subsection 27(i). In conjunction with this exemption, new subsection (j) requires separate accounts organized as management companies to comply with the provisions of amended section 26. Currently, section 27(c)(2) links the regulation of periodic payment plans to procedures established in section 26 for UITs even if the issuer is organized as a management investment company. Proposed section 27(j), in effect, preserves that cross-reference to ensure that the charges under variable contracts funded by trust or managed separate accounts would be treated alike.

#### **B. Disclosure Proposals**

If the Division's legislative proposal is enacted, the Division will give high priority to two specific disclosure projects: the design of a registration form for variable life insurance and the development of standardized hypothetical illustrations for use in both variable insurance prospectuses and supplemental sales literature. Improved disclosure is necessary to complement the added flexibility variable insurance issuers would have in pricing and distributing their contracts.

While variable annuity issuers register their contracts and separate accounts simultaneously in one registration statement, variable life issuers register their contracts on Form S-6 under the Securities Act and their separate accounts on Form N-8B-2 under the Investment Company Act.<sup>133</sup> Form S-6 is intended for the general use of all UITs registered on Form N-8B-2 and therefore does not contain requirements that are uniquely tailored to variable life insurance. Variable life insurance should have its own registration form, especially if the regulation of contract charges is changed as proposed.

The development of standardized hypothetical illustrations for variable life insurance is important in the context of the proposed amendments because the use of illustrations would improve an owner's understanding of contract charges and enable better cost comparison among competing contracts. As a result, there

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<sup>133</sup>Currently, no variable life insurance separate accounts are organized as management companies. A variable life separate account organized as a management company would register on Form N-1.

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should be greater price competition among issuers of variable life contracts.<sup>134</sup> The Division also expects the use of illustrations to help in evaluating whether a particular combination of contract charges is unreasonable.

Illustrations are an essential part of a variable life insurance prospectus. Although variable contract charges are disclosed in the prospectus, complicated contract designs make it difficult to understand the product and the effect of the charges without illustrations. Effective illustrations "interpret" charges by showing their impact on contract benefits. For example, variable life insurance illustrations show tabular presentations of cash values, cash surrender values, and death benefits over a twenty to thirty year period based on certain assumptions such as age, sex, health, and interest rates. Disclosure of fees and charges without accompanying illustrations means little to most investors.<sup>135</sup>

Illustrations currently are included in all variable life prospectuses and usually are adapted in supplemental sales literature to suit the specific characteristics of a contract owner. Because the illustrations are not based on standardized assumptions, however, they do not improve the comparability of contracts. In addition, issuers are uncertain about what assumptions are permissible in illustrations.

The need for standardized illustrations depicting charges during the pay-in phase of a variable annuity is less acute because of the mandatory use of fee tables.<sup>136</sup> The fee table is intended to improve an owner's understanding of the contract by requiring all charges to be presented as prescribed in an early part of the prospectus. Nevertheless, standardized illustrations with respect to a contract's pay-out phase would be beneficial. Illustrations are not generally used for variable annuities at the present time. Since 1979, when the Commission stated it would reconsider the appropriateness of mandatory hypothetical illustrations for variable annuities, registrants have not included illustrations in

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<sup>134</sup>See 1 BOOZ, ALLEN & HAMILTON, INC., *supra* note 130, at 111-113 to 111-115.

<sup>135</sup>This view was echoed by at least two commenters calling for relief from the provisions of sections 26 and 27. See Prudential Study Comment, *supra* note 63, at 116-118; LA Bar Study Comment, *supra* note 97, at 5-6; see also 1 BOOZ, ALLEN & HAMILTON, INC., *supra* note 130, at III-113-15 (concluding that it is very difficult for investors to compare the costs of alternative annuity contracts without the benefit of hypothetical illustrations).

<sup>136</sup>See Item 3 of Forms N-3 and N-4. There is no fee table requirement for variable life insurance, in large part because of the difficulty of presenting in a prospectus the cost of insurance charge, which differs for each individual.

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variable annuity prospectuses.<sup>137</sup> As more contract owners approach annuitization under these contracts, however, the Division has begun to receive requests to permit the use of illustrations during the pay-out phase.

## C. Effects

### 1. Investor Protection

Although the proposed amendments to sections 26 and 27 would change significantly the current charge restrictions for variable insurance products, the changes would not sacrifice investor protection. The Commission would have express authority to develop rules for determining the reasonableness of all variable insurance contract charges should they become necessary for the protection of investors. Of course, the wide array of state and federal regulations that currently applies to variable insurance operations will continue to apply.<sup>138</sup> Furthermore, the Division anticipates that the proposed amendments to sections 26 and 27, coupled with improved disclosure, will encourage market entry and improve price competition in the variable insurance industry to the ultimate benefit of investors.

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<sup>137</sup>In 1975, the Commission proposed to require the use of standardized hypothetical illustrations in variable annuity prospectuses. See Prospectuses of Variable Annuity Separate Accounts, Investment Company Act Release No. 8784 (May 9, 1975), 40 FR 23770. The industry objected to the form of the proposed illustrations. In 1979, when the Commission withdrew both its Statement of Policy, Advertising and Supplemental Sales Literature Used in Sale of Investment Company Shares, Investment Company Act Release No. 3385 (Aug. 14, 1950), 15 FR 5468, that sets forth the respects in which the Commission considers investment company sales literature to be misleading, and its proposal to require standardized illustrations, it indicated it would reconsider mandatory use of illustrations for variable annuities. Investment Company Sales Literature Interpretive Rule, Investment Company Act Release No. 10621 (Mar. 8, 1979), 44 FR 16935; Prospectuses for Variable Annuities; Withdrawal of Proposed Amendments to Forms S-5 and S-6, Investment Company Act Release No. 10789 (July 20, 1979), 44 FR 44552. Since then, despite adopting Forms N-3 and N-4 in 1985 and later amending them, the Commission has not taken any further action on variable annuity illustrations. See Registration Form for Insurance Company Separate Accounts that Offer Variable Annuity Contracts, Investment Company Act Release No. 14575 (June 14, 1985), 50 FR 26145 (adoption of Forms N-3 and N-4); Advertising by Investment Companies, Investment Company Act Release No. 16245 (Feb. 2, 1988), 53 FR 3868 (amendments to Form N-3 and N-4); Consolidated Disclosure of Variable Annuity Separate Account Expenses, Investment Company Act Release No. 16766 (Jan. 23, 1989), 54 FR 4772.

<sup>138</sup>Because of recent insurance company failures, Congress is considering whether the insurance industry as a whole should be subject to uniform federal solvency standards. See S. 1644, 102nd Cong., 1st Sess. (1991); see also Susan Pulliam, *Dingell Developing Insurance Industry Regulation Plan*, Wall St. J., Jan. 10, 1991, at A16, col. 4; Paulette Thomas, *Insurance Firms To Be the Focus of Senate Probe*, Wall St. J., Dec. 7, 1990, at A3, col. 1. The Division believes that the results of those deliberations should not affect its proposal.

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Adoption of the proposed amendments to sections 26 and 27 would change only the treatment of variable insurance as periodic payment plans, but would not otherwise affect federal securities regulation of variable insurance. Issuers would remain subject to the Securities Act and all other provisions of the Investment Company Act. Although a variable contract would no longer be subject to the sales load provisions of section 27, the Commission would retain the authority under the more flexible provisions of sections 22(b) and 22(c) to regulate variable contract sales charges. Section 36(b) would apply to investment advisory fees and other payments made to the investment adviser or its affiliates.

The disclosure obligations of the Securities Act will continue to be an essential feature of investor protection. Over the last two decades, the Commission has developed disclosure requirements to suit the unique nature of variable insurance so that consumers can make better investment decisions.<sup>139</sup> The Division will continue to focus on improving disclosure under variable contracts, particularly in conjunction with the proposed amendments. Improving a contract owner's ability to compare charges, especially through the use of standardized hypothetical illustrations, should foster competition among variable insurance issuers. Staff resources saved as a result of the proposed amendments could be allocated to this important project.

In addition, contract owners and purchasers of variable contracts will continue to benefit from important state law protections. State insurance law, particularly its nonforfeiture provisions, is designed to achieve objectives that are similar to the restrictions of sections 26 and 27. Like section 27(d) of the Investment Company Act, nonforfeiture law protects contract owners from paying excessive charges by limiting an insurer's deduction when an owner voluntarily surrenders his or her contract. In deciding what is appropriate for an insurer to retain, state officials, through the nonforfeiture requirements, attempt to balance the extent to which an insurer has not recovered the expenses incurred in issuing the contract and the extent to which the surrendering contract owner has prepaid for services for which he or she will never receive.<sup>140</sup> Because selling costs are

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<sup>139</sup>For example, in 1985 the Commission adopted Forms N-3 (for separate account management companies) and N-4 (for separate account UITs) to be used by issuers of variable annuity contracts. Inv. Co. Act Rel. 14575, *supra* note 137. In 1989, the Commission adopted amendments to these forms to require the inclusion of fee tables in variable annuity prospectuses. Inv. Co. Act Rel. 16766, *supra* note 137.

<sup>140</sup>See generally BLACK & SKIPPER, *supra* note 92, at 22, 355-64 (describing the principles underlying industry practices for determining the proper value to be granted to discontinuing contract owners).

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usually a key component of unamortized expenses,<sup>141</sup> nonforfeiture law, like section 27(d), helps to limit the amount of these expenses an insurer may keep.

Less directly, state reserve requirements, like sections 26 and 27 of the Investment Company Act, also protect a contract owner from paying excessive charges for contract services. The reserve requirements achieve this aim in two important respects: (1) by requiring that mortality costs be determined in accordance with prescribed mortality tables; and (2) by requiring that prepaid premiums or cash value be credited with a minimum rate of interest. While reserve requirements do not affect directly the amount of expenses that may be deducted under a contract, they generally assure the maintenance of minimum values so that guaranteed benefits can be provided.

Finally, state law provides an important protection that would be lost under the Division's proposal: the free-look right. Under the free-look provisions of section 27(f) and as modified in rules 6e-2 and 6e-3(T),<sup>142</sup> a contract owner has a certain time within which to return an excess loaded variable insurance contract and obtain a certain refund of premium payments. State law will continue to provide this important benefit.<sup>143</sup>

## 2. Regulatory Problems

Regulating variable contract charges as proposed would settle the Commission's longstanding dispute with the insurance industry over insurance-related charges, simplify substantive regulatory controls, streamline administrative procedures, and both conserve and better channel Commission resources.

The regulatory status of mortality and expense risk charges would be clarified because the Commission would have jurisdiction over all fees and charges assessed under a variable insurance contract. With clear jurisdiction over aggregate charges, including previously unregulated charges such as cost of insurance, the Commission would be in a better position to perform its regulatory function. The Commission would no longer have to separate the investment and insurance elements of a variable contract or determine whether each charge

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<sup>141</sup>A major portion of issuance expenses relates to selling costs. See McGill, *supra* note 92, at 253-54.

<sup>142</sup>Rules 6e-2(b)(13)(viii)(A), 6e-3(T)(b)(13)(viii)(A), 17 C.F.R. §§ 270.6e-2(b)(13)(viii)(A), .6e-3(T)(b)(13)(viii)(A).

<sup>143</sup>See, e.g., N.Y. INS. LAW § 3203(a)(11) (McKinney 1985 & Supp. 1992); CAL. INS. CODE § 10127.9 (West Supp. 1992); ILL. ANN. STAT. CH. 73 § 836(n) (Smith-Hurd Supp. 1991).

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satisfies regulatory limits. Insurers could not raise unregulated fees to avoid statutory or regulatory limits on regulated charges.

In addition to settling jurisdictional questions, the proposed legislation would improve the regulation of variable insurance simply because it would, for the first time, establish a regulatory framework specifically intended for variable insurance. The Commission would have a clear statutory mandate with respect to variable insurance regulation. As a result, it should be easier for the Commission to implement appropriate rules and policies with respect to variable insurance.

The simplification of the substantive regulation of sales loads would be a substantial benefit of the proposal. The Division currently expends considerable resources in monitoring compliance with the complex sales load requirements of section 27 and rules 6e-2 and 6e-3(T) under the Investment Company Act.<sup>144</sup> The proposed exemption from section 27 would make possible a simpler regulatory framework, but one that the Division believes would not sacrifice investor protection. In addition, adoption of the proposal would eliminate a substantial number of exemptive applications and protracted rulemaking projects.

### **3. Pricing and Distribution Problems of Variable Life Insurance**

The proposed amendments would address pricing and distribution problems currently experienced by variable life issuers. Under the proposal, issuers would obtain the needed flexibility to establish an appropriate price for a variable life insurance contract, a price that would reflect sufficiently a company's desire to recover and profit from its heavy capital investment in variable life insurance and to be competitive with fixed-dollar life contracts. This enhanced flexibility should foster the development of innovative variable life contracts and facilitate the reproduction of fixed-dollar contract designs. Consequently, the Division believes more insurers would be willing to offer variable life insurance.

The proposed amendments also would eliminate the refund requirements that currently make it difficult for an insurer to pay competitive commissions for selling variable and fixed life insurance contracts without a consequent strain on its capital and surplus. The expected parity in sales commissions that would result from the proposed amendments would end the current marketing bias against variable life insurance contracts. The Division expects that more insurance

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<sup>144</sup>See *supra* Section II.E.2.a.

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companies will expend the large sums needed to establish and maintain a variable life insurance operation knowing that they can pay the commissions necessary to ensure a vigorous sales effort from agents.

By eliminating the refund requirements of section 27 and the variable life rules, the proposed amendments would alter the method of calculating and the value of the refund a contract owner would receive upon surrender of a contract. Currently, surrender values are based on the amount of sales load paid by the contract owner.<sup>145</sup> Absent the refund requirements of section 27, surrender values would be determined by state nonforfeiture law which is based on cash value.<sup>146</sup> State nonforfeiture law generally provides for lower surrender values in the first twenty-four contract months than the values currently provided under rules 6e-2 and 6e-3(T).<sup>147</sup>

In the overall context of its proposal, however, the Division believes that state nonforfeiture law would provide a better accommodation between an insurer's desire to recover its unamortized expenses and the surrendering contract owner's desire to recover prepaid expenses.<sup>148</sup> The lower refund values, while placing variable life issuers on an equal basis with issuers of fixed-dollar contracts, would be balanced by Commission rulemaking authority in proposed section 26(e)(1). Moreover, state law will continue to provide important rights in early contract months to contract owners. Importantly, under state free-look provisions, a contract owner will be permitted to return his or her contract within a certain time of purchase and recover some or all of the premium payments.

Like so many of the policies established for variable insurance, decisions regarding surrender values were made at a time when variable insurance was an infant industry and the Commission had limited experience with insurance products.<sup>149</sup> The Division now believes that section 27 should not apply to

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<sup>145</sup>See *supra* note 62 and accompanying text.

<sup>146</sup>The Commission has considered using a cash value approach to the refund requirement in the past, but has not elaborated on its decision to reject that approach. See Inv. Co. Act Rel. 9482, *supra* note 55.

<sup>147</sup>See BLACK & SKIPPER, *supra* note 92, at 362 (using tables to illustrate the effects of different assumptions on nonforfeiture values).

<sup>148</sup>See *supra* note 140 and accompanying text.

<sup>149</sup>The refund formula of current regulation appears to have been based primarily on the design of the first scheduled premium life insurance contract to register with the Commission. (continued..)

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variable life insurance contracts. As stated elsewhere, variable life insurance contracts are very different from the periodic payment plans that generated the refund provisions of section 27 and should be regulated differently.

#### **4. A Practical Approach to Variable Annuities**

Under the proposal, there would be no specific limit on mortality and expense risk charges except as part of the issuer's determination that aggregate contract charges are reasonable. In theory, the proposal could therefore exacerbate current problems by effectively permitting variable life and variable annuity issuers to increase the amount of mortality and expense risk charges and therefore the percentage of those charges that could be used to pay for distribution or other expenses.

The Division acknowledges that there is some possibility for abuse, particularly in the case of variable annuities. While greater charge flexibility is supported for variable life insurance contracts because of the traditional and significant insurance elements of those contracts, the industry does not make that argument for variable annuities. We agree that variable annuities, during the pay-in phase, are more likely than life insurance to be offered in competition with mutual funds. We also acknowledge that variable annuity issuers offer purchasers something more than a traditional mutual fund for which a fee is appropriate, but it is difficult to determine the value of those services. The Division's proposal reflects these considerations and the conclusion that full disclosure **of** charges is a more practical solution. If specific abuses develop in the future, the proposal would allow the Commission to address them through rules and regulations providing standards for defining the reasonableness of fees and charges.

Further, the Division believes that the proposed legislative amendments and subsequent disclosure changes will improve the comparability of variable annuity contracts generally and also with respect to mutual fund investments. The enhanced comparability will lead to even greater price competition in the variable annuity market.

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<sup>149</sup>(...continued)

According to at least one commenter, that contract was inappropriately priced in an effort to address Commission concern over sales loads and congressional action amending section 27(d) in 1970. Prudential Study Comment, *supra* note 63, at 57-61, 89-99.

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## 5. Increased Competition

Many United States life insurers do not offer variable products, in part, according to some commenters, because of restrictive regulation under sections 26 and 27 of the Investment Company Act.<sup>150</sup> The Division believes that the proposed changes to variable insurance regulation would ease barriers to market entry and enhance competition in the industry. Improved competition should benefit investors by lowering contract prices and stimulating product development.

There is evidence that competition in the insurance industry already operates to keep charges at a reasonable level. Apparently, most insurers currently provide nonforfeiture values in excess of statutory minimum requirements.<sup>151</sup> In addition, despite having the ability to deduct excess loads under variable annuities, practically all insurers use a level load design.<sup>152</sup> Even with the small number of companies offering variable insurance, competition appears to have been the key factor in steering prices below statutory limits. The Division believes that the proposal would foster even more competition to the benefit of contract owners.

The ACLI has noted that products structurally similar to variable insurance contracts have been offered in other countries and that such products are more attractive than United States variable insurance contracts.<sup>153</sup> According to the ACLI, part of that success may be due to less stringent regulation in those countries and the relatively lower cost of foreign products.<sup>154</sup> In any event, successful foreign sales of variable insurance support the Division's belief that these contracts are desirable products for many consumers. By adopting a more flexible approach to variable insurance regulation, the Division believes that eventually these contracts will be more widely available in the United States.

The Division also expects that the proposal would encourage United States issuers to sell their variable insurance products abroad. According to the ACLI,

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<sup>150</sup>See, e.g., **ACLI Study Comment**, *supra* note 75, at 41-43; **Prudential Study Comment**, *supra* note 63, at 104-05.

<sup>151</sup>See **BLACK & SKIPPER**, *supra* note 92, at 356-57.

<sup>152</sup>The Division is aware of only one company that currently offers an excess-loaded variable annuity contract.

<sup>153</sup>See **ACLI Study Comment**, *supra* note 75, at 43-45.

<sup>154</sup>*Id.* at 44.

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because United States insurance companies are restricted by sections **26** and **27** of the Investment Company Act, they are unable to design products that would compete effectively in foreign markets. The **ACLI** asserts that insurance products in many foreign countries are simpler than variable products sold in the United States because they are not subject to as many regulatory constraints.<sup>155</sup>

## V. Conclusion

The Division recommends that the Commission propose legislation to amend sections **26** and **27** to exempt variable insurance contracts from the specific charge limitations under those provisions, and instead create restrictions against unreasonable aggregate fees. In connection with this proposal, the Division will give priority to the development of a registration form for variable life insurance and standardized illustrations for variable insurance contracts. The Division believes that the proposed amendments to sections **26** and **27**, together with improved disclosure, will resolve significant problems associated with the regulation of variable insurance charges under the Investment Company Act and continue to provide important investor protections under the federal securities laws.

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<sup>155</sup>*Id.*

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## APPENDIX 10-A

### Red-Lined Version of Proposed Amendments to the Investment Company Act of 1940

(new language is shaded, deleted language is struck through)

**Section 26** [15 U.S.C. § 80a-26]. (a) No principal underwriter for or depositor of a registered unit investment trust shall sell, except by surrender to the trustee for redemption, any security of which such trust is the issuer (other than short-term paper), unless the trust indenture, agreement of custodianship, or other instrument pursuant to which such security is issued --

\* \* \*

(5) Subsection (a) shall not apply to any registered separate account funding variable insurance contracts, or to the sponsoring insurance company and principal underwriter of such account.

\* \* \*

(e) It shall be unlawful for any registered separate account funding variable insurance contracts, or for the sponsoring insurance company of such account, to sell any such contract, unless -

(1) the fees and charges deducted under the contract in the aggregate are reasonable in relation to the services rendered, the expenses expected to be incurred and the risks assumed by the insurance company, and the insurance company so represents in the registration statement for the contract. The Commission, by such rules and regulations as it deems necessary and appropriate in the public interest for the protection of investors, may prescribe guidelines for determining the reasonableness of such fees and charges; and

(2) the insurance company (A) complies with all other applicable provisions of section 26 as if it were a trustee or custodian of the registered separate account; (B) files with the insurance regulatory authority of a state or territory of the United States or of the District of Columbia an annual statement of its financial condition in the form prescribed by the National Association of Insurance Commissioners, which most recent statement indicates that it has a combined capital and surplus, if a stock company, or an unassigned surplus, if a mutual company, of not less than \$1,000,000; and (C) together with its registered separate accounts, is supervised and examined.

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periodically by the insurance authority of such state, territory or the District of Columbia.

Section 27[15 S.C. § 1]

\* \*

(i) This section shall not apply to any registered separate account funding variable insurance contracts, or to the sponsoring insurance company and principal underwriter of such account, except as provided in subsection (j).

(j) It shall be unlawful for any registered separate account funding variable insurance contracts, or for the sponsoring insurance company of such account, to sell any such contract unless the insurance company complies with section 26(e) and any rules or regulations adopted by the Commission thereunder.

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## Chapter 11

# Repurchases and Redemptions of Investment Company Shares

### I. Introduction and Summary of Recommendations

The earliest United States management investment companies were closed-end, and closed-end companies far outnumbered their open-end counterparts at the time of the enactment of the Investment Company Act;<sup>1</sup> since then, however, open-end companies have been considerably more popular with investors. A major reason for that popularity is that the redemption rights of open-end shares assure shareholders of being able to exchange their shares for net asset value, whereas closed-end securities have no such rights and often trade in the market at a discount to net asset value after the initial public offering is completed.

At the same time, the closed-end form has attracted renewed interest. For example, the increasingly global marketplace has caused sponsors to reconsider closed-end companies as investment vehicles. Open-end companies operate subject to a liquidity standard that restricts their ability to invest in less liquid securities, such as some foreign securities.<sup>2</sup> Because closed-end companies do not issue redeemable securities, they are not subject to a liquidity standard. Thus, sponsors wishing to offer investment companies with portfolios consisting of less liquid securities must choose the closed-end form.

The Investment Company Act contains a rigid classification system from which many important regulatory consequences flow. Investment companies are divided into "face-amount certificate companies," "unit investment trusts," and "management companies." Management companies in turn are divided into "open-end" and "closed-end." These terms are defined comprehensively so that every investment company fits within a particular classification and subclassification.<sup>3</sup> The classification system is crucial to an investment

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<sup>1</sup>Investment Company Act of 1940, 15 U.S.C. § 80a.

<sup>2</sup>An open-end company's aggregate holdings of illiquid securities may not exceed 15% of the company's net assets. See *infra* note 34 and accompanying text.

<sup>3</sup>Section 4 of the Act contains fairly specific definitions for face-amount companies and unit investment trusts, while management companies are defined simply to mean any investment company other than a face amount company or a unit investment trust. 15 U.S.C. § 80a-4. Similarly, section 5 of the Act defines what is meant by open-end company, and then defines (continued...)

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company's structure and operation because specific statutory requirements will apply or not apply depending on the classification of the particular company.

Section 5(a) defines an open-end company as a management company that issues or has outstanding any "redeemable security."<sup>4</sup> All other management companies are closed-end. A redeemable security entitles the holder to receive, upon presentation to the issuer, the holder's approximate proportionate share of the issuer's current net assets, or the cash such share represents?

Open-end and closed-end companies are subject to many of the same key provisions of the Act, including prohibitions on affiliated transactions in section 17, requirements for a written advisory contract approved by shareholders in section 15, requirements attending the composition and operations of the board of directors in sections 10 and 16, and the anti-pyramiding and investment restrictions in section 12(d).<sup>6</sup> Nevertheless, the fact that open-end shareholders have redemption rights and closed-end shareholders do not leads to many differences in the regulatory treatment of open-end and closed-end companies under the Act.

For example, section 18 restricts the use of leverage by both open-end and closed-end companies but treats the two types of companies quite differently.<sup>7</sup> While closed-end companies may issue "senior securities" such as debt and preferred stock under certain circumstances, open-end companies may not.<sup>8</sup> This marked difference in how open-end and closed-end companies may organize their capital structures is due, in part, to the nature of redeemable securities. Nothing would prevent the holders of the junior securities (the common stock) in an open-end company from redeeming the equity that normally acts as a "cushion"

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<sup>3</sup>(...continued)

closed-end company as any management company other than an open-end company. 15 U.S.C. § 80a-5. The presence of these "catch-all" categories ensures that the classification system encompasses the entire universe of investment companies.

<sup>4</sup>15 U.S.C. § 80a-5(a).

<sup>5</sup>Investment Company Act § 2(a)(32), 15 U.S.C. § 80a-2(a)(32).

<sup>6</sup>15 U.S.C. §§ 80a-17, -15, -10, -16, -12(d).

<sup>7</sup>15 U.S.C. § 80a-18.

<sup>8</sup>Section 18 does, however, permit open-end companies to borrow from banks under certain conditions.

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supporting the payment obligations on senior securities; such senior securities thus would be fundamentally unsound investments.

Section 22 of the Act imposes specific requirements governing the pricing and redemption of open-end shares.<sup>9</sup> Different requirements apply to non-redeemable shares of closed-end companies under section 23,<sup>10</sup> which permits closed-end companies to repurchase their shares from investors on the open market (after notice to shareholders), pursuant to tender offers, or in compliance with Commission rules or orders>\*

Because of the special nature of redeemable securities, open-end and closed-end companies distribute their shares quite differently. Open-end companies are subject to constant liquidation pressures from shareholders, who may decide to redeem their shares at any time. To replenish the monies withdrawn, open-end companies generally offer and sell new shares to the public on a continuous basis. Closed-end companies, on the other hand, generally engage in traditional underwritten offerings of a fixed number of shares (either through an initial public offering or a series of discrete offerings) and in most cases do not offer their shares to the public on a continuous basis.

Another major difference between open-end and closed-end companies is that closed-end shares usually are traded in secondary markets, either on exchanges or over the counter, whereas open-end shares are not. This difference stems from section 22(d) of the Act, which in effect fixes the prices at which open-end shares are sold. The result is a system of retail price maintenance that precludes dealers from making a secondary market in open-end shares.<sup>12</sup>

As a result of market fluctuations, closed-end shareholders selling in the secondary market may receive more or less than the net asset value of the shares.<sup>13</sup> Closed-end securities often trade at a discount to net asset value in the

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<sup>9</sup>15 U.S.C. § 80a-22.

<sup>10</sup>15 U.S.C. § 80a-23.

<sup>11</sup>As discussed *infra* notes 19-26 and accompanying text, repurchase procedures are controlled strictly due to the numerous abuses that existed prior to the Act's passage. Repurchases are different from redemptions by open-end companies because the closed-end company may decide whether, when, and how much of its securities to repurchase, and because the repurchases generally do not occur often or regularly.

<sup>12</sup>For a detailed discussion of the effects of this system of retail price maintenance on mutual fund distribution, see Chapter 8.

<sup>13</sup>In contrast, open-end shareholders tendering their shares are assured of receiving net asset value, less any deferred sales load or redemption fee.

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secondary market, a situation that has adverse consequences for both investors and sponsors. Some investors lose money when discounts develop; others may profit as discounts diminish. Persistent discounts in the marketplace also make it more difficult for sponsors to launch new closed-end companies. In addition, discounts prevent existing companies from raising capital because the Act generally prohibits closed-end companies from selling new shares at less than net asset value.<sup>14</sup> While some closed-end companies have sought to minimize market discounts by repurchasing their shares, they have been unable to commit to repurchases in advance due to concerns that such an advance commitment may be inconsistent with the fiduciary obligations of closed-end company directors.<sup>15</sup>

Despite significant problems **with** the closed-end form, recently some sponsors have used it to offer interests in portfolios consisting of foreign securities and new types of less liquid securities such as participation interests in corporate loans. Use of the closed-end form to offer these types of portfolios raises questions about the restrictiveness of the Act's classification system, which currently forces companies to be either open-end (and highly liquid) or closed-end. Under the existing system of regulation, neither form appears to provide the best vehicle for offering portfolios that have substantial but not complete liquidity.

Given the changes that have occurred in the securities markets since 1940, it is appropriate to re-examine the classification system and its current regulatory requirements. Sponsors organizing an investment company in 1940 did not have available the vast array of semi-liquid portfolio securities that exists today. Today, however, the rigidity of the Act's classification system has become a limitation on sponsors' ability to offer innovative products. The Division has concluded it would be appropriate to provide the opportunity for investment companies to chart new territory between the two extremes of the open-end and closed-end forms, consistent with investor protection.

The Division has examined several alternatives. We considered amending the statutory definition of the closed-end and open-end forms to provide additional flexibility. We also considered recommending either legislation or Commission rulemaking that would permit development of a third, entirely new form of investment company that would combine characteristics from each of the other two. These alternatives did not seem to respond to the problems that

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<sup>14</sup>Investment Company Act § 23(b). It is also likely that investors would not buy shares priced at net asset value if they could obtain them for less in the secondary market.

<sup>15</sup>See *infra* notes 86, 88 and accompanying text.

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prompted our examination or to provide for the range of investment choices we believe is necessary for effective reform.

The Division recommends giving the industry the ability to employ new redemption and repurchasing procedures, subject to Commission rulemaking and oversight. First, the Division recommends that the Commission adopt a new rule under section 23 of the Act that would permit closed-end companies to conduct periodic repurchases of their shares at net asset value under specified circumstances. The Division also recommends that the Commission adopt a new rule under section 22 of the Act permitting a new variation within the open-end form (to be called a "limited redemption" investment company) to offer alternative redemption and offering procedures to investors. Finally, the Division recommends that the Act be amended to impose an express portfolio liquidity requirement on all management investment companies that redeem or regularly repurchase their shares. Liquidity requirements would help protect investors' reasonable expectations regarding their ability to exit a particular company at net asset value.

This chapter begins by exploring further the dichotomy between open-end and closed-end investment companies under the Act. It then discusses our recommendation to facilitate periodic repurchases of closed-end securities, followed by our recommendation for developing new limited redemption investment companies. The chapter continues with our proposal for amending the Act to provide the Commission with express authority to impose liquidity requirements on all investment companies that redeem or periodically repurchase their shares. It closes with an analysis of the consistency of our recommendations with prior interpretations of the definition of "redeemable security" in section 2(a)(32) of the Act.<sup>16</sup>

## **II. Background**

### **A. The Treatment of Open-End and Closed-End Investment Companies Under the Act: The Historical Context**

The Act's delineation of the closed-end and open-end categories responded to the characteristics of the investment company industry in the decades preceding the Act and sought to correct certain abuses and problems. Closed-end companies became prominent during the 1920's, when new issues quickly sold

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<sup>16</sup>15 U.S.C. § 80a-2(a)(32).

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out at large premiums over net asset value.<sup>17</sup> The stock market crash of 1929 virtually eliminated the market for new public offerings of closed-end securities, however, and closed-end shares began trading in the secondary market at prices below net asset value. Open-end companies, relatively unknown before the crash, quickly became popular because they offered protection from discounts by committing to redeem investors' shares at net asset value.

Although the open-end company was a fairly new form of investment vehicle in 1940, the Commission's Study on Investment Trusts and Investment Companies (the "Investment Trust Study") documented extensive abuses in the operations of both open-end and closed-end investment companies.<sup>18</sup> Not surprisingly, abuses were often related to practices that gave preferential treatment to investment company insiders and affiliates. Three areas in particular provided substantial opportunity for abuse. Closed-end companies had aggressively repurchased their shares in response to discounts, often manipulating the market for shares in ways that benefitted management and insiders to the detriment of selling shareholders. Similarly, open-end companies had engaged in questionable pricing and distribution practices in connection with their ongoing sales and redemptions procedures. Finally, complex capital structures, particularly in closed-end companies, had resulted in dangerous leveraging effects that threatened the viability of many investment companies. These abuses, and the provisions of the Investment Company Act and rules that address them, are discussed more fully below.

## 1. Repurchases of Closed-End Shares

The condition of the market during the 1920's and 1930's provided powerful incentives for closed-end companies to engage in extensive repurchase operations.<sup>19</sup> While repurchasing of shares is not, in itself, an abusive practice, certain strategies used by closed-end companies during the period of **1927-1935** resulted in market manipulation and harm to public shareholders.

Before the crash, it was not unusual for sponsors of closed-end companies to instigate repurchases for the purpose of influencing the market to aid in the

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<sup>17</sup>Alfred Jaretzki,Jr., *The Investment Company Act of 1940*, 26 WASH. U. L. Q. 303,306 (1941). The tremendous growth of closed-end companies during the 1920's apparently was closely tied to public confidence in the investment houses sponsoring them. *Id.*

<sup>18</sup>SEC, INVESTMENT TRUSTS AND INVESTMENT COMPANIES,pt. 3, H.R. Doc. No. 279, 76th Cong., 1st Sess. (1939) [hereinafter INVESTMENT TRUST STUDY, pt. 31].

<sup>19</sup>*Id.* at 954. From 1927 through 1935, closed-end companies and their affiliated holding companies repurchased a net amount of \$472 million of their securities, or about 12% of the securities issued and sold by closed-end companies during that period. *Id.* at 935-54.

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distribution of new shares?” Repurchases could support or increase the market price, creating an appearance that the value of the shares was steady or rising, and enhancing the value of the sponsors’ own holdings?<sup>20</sup>

After the crash, repurchases often were made for different reasons. As the price of closed-end shares fell to a discount, repurchases at discount prices became a source of book profits for closed-end companies. Many times, however, the profits were made at the expense of selling shareholders who had no way of knowing the extent of the discount and, therefore, the extent to which they were liquidating their shares at prices that did not reflect their true value.<sup>21</sup> This was possible because closed-end companies did not disclose the net asset value of their shares. In addition, because some companies made purchases on the open market without informing investors, investors could not determine the extent to which the market was being driven by the company’s management.<sup>22</sup>

Other abuses occurred. Some closed-end companies would repurchase securities from insiders in private purchases, sometimes at a premium or in blocks that could not have been sold at the prevailing market price because of the size of the purchase.<sup>23</sup> Some companies would repurchase from certain shareholders to establish control or remove opposition to management.<sup>24</sup> Finally, repurchases were used in various ways in connection with mergers, consolidations, and acquisitions. Some companies, for example, made repurchases to manipulate the market values of securities involved in exchanges.<sup>25</sup>

In response to these abuses, Congress enacted section 23 of the Investment Company Act. Section 23(c) restricts repurchases of closed-end company shares, limiting them to purchases (1) on a national securities exchange or other market designated by the Commission (after adequate notice to all shareholders); (2) pursuant to tenders open to all security holders; or (3) in such other circumstances as the Commission permits by rule or order. Section 23 also regulates additional sales of common stock by closed-end companies after the

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<sup>20</sup>*Id.* at 956-57.

<sup>21</sup>*Id.* at 960-61.

<sup>22</sup>*Id.* at 966-67.

<sup>23</sup>*Id.*

<sup>24</sup>*Id.* at 977-78. Repurchases at a premium to market price were particularly troublesome because they diluted the company’s assets for the benefit of the insider seller.

<sup>25</sup>*Id.* at 997.

<sup>26</sup>*Id.* at 1009.

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initial offering is completed. Section 23(b) generally prohibits such sales at prices below net asset value, except (1) in connection with an offering to holders of one or more classes of capital stock; (2) with the consent of a majority of the holders of common stock; (3) upon conversion of a convertible security in accordance with its terms; (4) upon the exercise of any warrant issued in accordance with the provisions of section 18(d); or (5) under such other circumstances as the Commission may permit by rule or order. These provisions are aimed at protecting existing shareholders from the effects of sales of new shares that would unfairly dilute their holdings.

## 2. Pricing and Redemption of Open-End Shares

Abusive practices also occurred with early open-end companies that claimed that their securities were redeemable, but then instituted barriers to redemption. Redemptions typically were suspended because a company was redeeming more shares than it was selling and wanted to stop net redemptions from further diminishing assets and decreasing management fees; some companies apparently suspended redemptions to prevent shareholders from switching into other funds.<sup>27</sup> Companies often suspended redemptions based on provisions contained in charter documents that shareholders never saw.<sup>28</sup> Even if there could be no suspension without a shareholder vote, management could persuade shareholders to vote for suspension by offering a plausible explanation of why suspension was necessary.<sup>29</sup>

There also were abuses associated with the pricing of redeemable securities. Most significantly, open-end companies engaged in "backward pricing," under which investors were priced into the fund based on the net asset value of the fund on the previous day. In a rising market, insiders and favored customers, who did not pay a sales load, could purchase shares based upon the previous day's lower price, turn around and redeem their shares the next day, and be assured of riskless profits, which resulted in dilution of the remaining shareholders' holdings.

Section 22 of the Investment Company Act regulates the pricing, distribution, and redemption of open-end company securities. Paragraph (c) of section 22 gives the Commission broad power to regulate the pricing of redeemable securities, including the power to prescribe by rule methods for

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<sup>27</sup>See *Investment Trusts and Investment Companies: Hearings on S. 3580 Before a Subcomm. of the Senate Comm. on Banking and Currency, 76th Cong., 3d Sess. 291-92 (1940)* [hereinafter 1940 Senate Hearings] (statement of David Schenker, Chief Counsel, SEC Investment Trust Study).

<sup>28</sup>See *id.* at 291.

<sup>29</sup>See *id.* at 292.

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computing the price a shareholder will receive upon redemption?' Rule 22c-1 makes backward pricing illegal for open-end companies and, instead, institutes a requirement of "forward pricing" based on a daily computation of net asset value.<sup>31</sup> These provisions are intended to prevent dilution and assure that prices bear an appropriate relation to the current net asset value of the shares.<sup>32</sup>

Paragraph (d) of section 22 requires that open-end securities be sold only at the current offering price described in the prospectus. This subsection, designed at least in part to prevent insider riskless trading and the resulting dilution, has resulted in a system of retail price maintenance that fixes open-end share prices and prevents dealers from making a secondary market.<sup>33</sup> Paragraph (e) of section 22 provides that registered open-end companies may not suspend the right of redemption, and must pay redemption proceeds within seven days. That subsection recognizes that open-end companies might need to suspend redemptions in certain emergencies, however, or for such periods as the Commission may by order permit.

Because open-end companies must redeem their shares at any time and pay redemption proceeds within seven days, their portfolios must contain enough readily marketable securities to enable them to raise sufficient cash to meet redemptions in a timely manner. To ensure that open-end companies will be able to meet their redemption obligations, the Commission has indicated that they should maintain at least eighty-five percent of their assets in "liquid" securities for which there are readily available market prices.<sup>34</sup>

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<sup>30</sup>Section 22(c) gives the Commission powers similar to those given to registered securities associations under sections 22(a) and (b) in connection with the promulgation of rules governing member activities with respect to the pricing and distribution of redeemable securities. Section 22(c) specifically provides that Commission rules preempt any conflicting rules adopted by securities associations.

<sup>31</sup>17 CFR. § 270.22c-1. Specifically, rule 22c-1 provides that open-end securities may not be sold, redeemed, or repurchased "except at a price based on the current net asset value of such securities which is next computed *after* receipt of a tender of such security for redemption or of an order to purchase or sell such security" (emphasis added).

<sup>32</sup>See Adoption of Rule 22c-1 under the Investment Company Act of 1940 and Amendment of Rule 17a-3(a)(7) under the Securities Exchange Act of 1934, Investment Company Act Release No. 5519 (Oct. 16, 1968), 33 FR 16331.

<sup>33</sup>See Chapter 8.

<sup>34</sup>See Guide 4 to Form N-1A, Revision of Guidelines to Form N-1A, Investment Company Act Release No. 18612 (March 12, 1992), 57 FR 9828. See also Interpretative Releases Relating to the Investment Company Act of 1940 and Rules and Regulations Thereunder: Restricted Securities, Investment Company Act Release No. 5847 (Oct. 21, 1969), 35 FR 19989 (interpretive release (continued...)

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If a certain level of liquidity were not required, an open-end company could maintain a portfolio that would make it difficult to meet the seven day deadline in section 22(e). The company might be forced to sell illiquid assets for less than the best price, diluting the company's net asset value for the non-redeeming shareholders. Alternatively, if the level of liquidity were simply inadequate, the investment manager may have to sell more liquid assets that otherwise would have been kept on the basis of comparative investment merit. These transactions could affect performance, thus harming shareholders who did not redeem.<sup>35</sup>

### 3. Use of Leverage

Leverage, applied to investment company assets through excessive borrowing and the issuance of excessive amounts of senior securities, was a primary concern that led to the Act's passage.<sup>36</sup> Leverage introduces an element of speculation to both the junior and senior shares. Nevertheless, many public investors did not understand how leverage affected their investment or even how their holdings fit within the investment company's overall capital structure.<sup>37</sup>

Typically, sponsors and others in the securities business held most of an investment company's equity securities (*i.e.*, common stock) and authorized successive issues of debt and preferred stock to be sold to the public.<sup>38</sup>

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<sup>34</sup>(...continued)

regarding investment by investment companies in restricted securities); Resale of Restricted Securities; Changes to Methods of Determining Holding Period of Restricted Securities under Rules 144 and 145, Securities Act Release No. 6862 (Apr. 23, 1990), 55 FR 17933 (adopting rule 144A).

<sup>35</sup>Closed-end companies are not subject to a liquidity requirement because they do not redeem shares on a daily basis. Of course, closed-end companies may need a certain degree of liquidity in order to generate cash to pay expenses and to pay cash dividends and distributions if any. Some amount of liquidity also may be desirable to the extent necessary to pay holders of senior debt securities such as preferred stock or, as recommended later in this chapter, in the event the company repurchases its shares.

<sup>36</sup>See Investment Company Act § 1(b)(7), 15 U.S.C. § 80a-1(b)(7). Almost 400 pages of the INVESTMENT TRUST STUDY are devoted to problems in connection with capital structure. INVESTMENT TRUST STUDY, pt. 3, *supra* note 18, at 1563-936.

<sup>37</sup>INVESTMENT TRUST STUDY, pt. 3, *supra* note 18, at 1674-75.

<sup>38</sup>Complex capital structures were common. About 75% of closed-end companies used some form of leverage. SEC, INVESTMENT TRUSTS AND INVESTMENT COMPANIES, pt. 1, H.R. Doc. NO. 707, 75th Cong., 3d Sess. at 29 (1938); INVESTMENT TRUST STUDY, pt. 3, *supra* note 18, at 1582. Use of leverage by open-end companies apparently was rare. Id. at 838 (describing one **case of a leveraged open-end company**).

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Purchasers of senior securities, many of whom were individual investors, bought the securities in the belief that they were "safe" investments.<sup>39</sup> These investors often had no voting rights!<sup>40</sup> As a result, the equity holders were able to gain control over substantially more capital than they themselves invested.<sup>41</sup> In addition, the equity holders could induce the company to repurchase their shares, thereby reducing the capital available to generate income to pay the senior holders.<sup>42</sup>

Leverage not only presents dangers to the senior holders, it increases dramatically the speculative nature of the equity securities. Because the equity securities receive the benefits of all capital appreciation, and absorb all capital losses or asset depreciation, the value of the equity shares rises or falls faster than changes in the market value of the underlying assets of the leveraged investment company.<sup>43</sup> The effects of leverage are accentuated if equity shares may be repurchased or redeemed, exposing the remaining equity holders to higher risks as well as higher returns.

Section 18 of the Act limits the use of leverage by both closed-end and open-end investment companies, but treats the two types of companies very differently. Closed-end companies may borrow from banks and private sources and may issue one class of senior debt, subject to a 300% asset coverage requirement, and also may issue one class of preferred stock, subject to 200% asset coverage requirement.<sup>44</sup> Among other restrictions, a leveraged closed-end company may not pay dividends or other distributions, or purchase any of its capital stock, unless the prescribed asset coverage will be in place after the transaction. Provision also must be made to give senior security holders certain

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<sup>39</sup>INVESTMENT TRUST STUDY, pt. 3, supra note 18, at 1594.

<sup>40</sup>*Id.* at 1597.

<sup>41</sup>*Id.* at 1594-95.

<sup>42</sup>See *id.* at 1001.

<sup>43</sup>*Id.* at 1000-01. In contrast, senior securities represent a fixed charge on the assets of the company and do not share in these gains or losses.

<sup>44</sup>Paragraph (h) of the section defines asset coverage. For example, a closed-end company with \$100 million in assets and no other outstanding indebtedness may issue senior debt of up to \$50 million. The ratio of the total assets after the borrowings (\$150 million) to the amount of debt outstanding (\$50 million) would be 300%. The same company also may issue preferred stock having a liquidation preference of \$50 million. The ratio of the total assets of the company after the issuance (\$200 million) to the aggregate of borrowings and preferred stock (\$100 million) would be 200%.

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rights if the asset coverage falls below the prescribed amounts.<sup>45</sup> Open-end companies, because they issue redeemable securities, are permitted much less freedom to use leverage. They may borrow only from banks and must maintain 300% asset coverage for all amounts borrowed.<sup>46</sup>

## B. The Re-Emergence of Closed-End Companies and the Problem of Discounts

In **1940**, open-end companies had assets only two-thirds as great as those of closed-end companies.<sup>47</sup> By **1950**, open-end company assets had grown to nearly three times those of closed-end companies!<sup>48</sup> This trend continued until the latter half of the **1980's**, when closed-end companies experienced a resurgence. In **1986**, there were **69** closed-end companies with **\$12** billion in assets.<sup>49</sup> By the end of **1991**, there were **290** closed-end companies with almost **\$73** billion in assets.<sup>50</sup> Although this increase is impressive, the total assets of closed-end companies still are small in comparison to those of open-end companies which, as of the end of **1991**, amounted to approximately \$1.3 trillion.<sup>51</sup>

Despite their relative lack of popularity, there are a number of reasons why sponsors choose the closed-end form. Because closed-end companies do not sell or redeem their shares continuously, and thus need not take cash inflows and outflows into account in managing their portfolios, closed-end companies arguably have an advantage over open-end companies in efficiency of portfolio management. While open-end companies must maintain a certain amount of cash or highly liquid investments to meet daily redemptions, closed-end companies

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<sup>45</sup>Investment Company Act § 18(a).

<sup>46</sup>Investment Company Act § 18(f)(1).

<sup>47</sup>1940 Senate Hearings, *supra* note 27, at 43.

<sup>48</sup>Information compiled by the Division from data prepared by Lipper Analytical Services, Inc., the Investment Company Institute (the "ICI"), Arthur Wiesenberger, and Wiesenberger Financial Services.

<sup>49</sup>*Id.*

<sup>50</sup>Lipper Analytical Services, Inc., Lipper Closed-End Fund Performance Analysis Service 44 (Jan. 31, 1992).

<sup>51</sup>Investment Company Institute News Release, ICI-92-03 (Jan. 29, 1992). This figure does not include monies invested in unit investment trusts and variable insurance products.

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may keep their assets fully invested according to their investment objectives.<sup>52</sup> More importantly, the closed-end form enables sponsors to offer companies with investment portfolios that could not meet the liquidity requirements imposed on open-end companies. Because closed-end companies do not issue redeemable securities, the Act permits them greater use of leverage than open-end companies, providing investors with the opportunity for greater returns (as well as greater risks).<sup>53</sup>

Internationalization of the securities markets and optimism about emerging markets overseas have created significant opportunities for new offerings of closed-end companies in recent years. So-called "country funds" have provided an important medium for United States investors to invest overseas.<sup>54</sup> Country fund portfolios often contain a large percentage of securities that are thinly traded or are considered to be illiquid for other reasons. For example, the size of the fund may be relatively large in relation to the overall capitalization of an emerging market and enormous in proportion to the daily trading volume. In addition, securities transactions in foreign countries may be subject to slower settlement procedures than those in the United States, or currency restrictions may limit a fund's ability to convert cash into United States dollars. These portfolios also may be difficult to value, due to limited data on market prices.

Beginning in late 1989, there was a surge of investor interest in single country closed-end companies. During this period, the shares of many country funds were trading at significant premiums to their net asset values. Market prices shortly plummeted, however, with share prices dropping on average 31% during 1990.<sup>55</sup> While the drop may have resulted from the large number of new

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<sup>52</sup>See, e.g., Request for Comments on Reform of the Regulation of Investment Companies, Investment Company Act Release No. 17534 (June 15, 1990), 55 FR 25322 [hereinafter Study Release]. See also Letter from General American Investors Company, Inc. to Jonathan G. Katz, Secretary, SEC 4 (Oct. 3, 1990), File No. S7-11-90 [hereinafter General American Study Comment]; and Letter from Baker, Fentress & Company to Jonathan G. Katz, Secretary, SEC 2 (Oct. 9, 1990), File No. S7-11-90 [hereinafter Baker, Fentress Study Comment].

<sup>53</sup>Many, if not most, closed-end companies do not issue significant amounts of senior securities, however. Currently, the issuance of senior securities is most common among closed-end bond funds, particularly municipal bond funds. Edward A. Wyatt, *On Borrowed Time? Leveraged Funds' Promise -- and Perils*, BARRON'S, Nov. 11, 1991, at M16. Some investors may view these senior securities as a higher income alternative to investing in a tax-exempt money market fund. See James E. Lebherz, *Mutual Funds' Preferred Shares Offer an Alternative to Investors*, WASH. POST, Aug. 25, 1991, at H10.

<sup>54</sup>Some of these companies invest in a number of countries; others invest only in a particular geographical region or in a single country.

<sup>55</sup>See Jonathan Clements, *Country Fund Fever Leaves Investors Feeling Queasy*, WALL ST. J., Jan. 22, 1991, at C1.

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companies launched or fading enthusiasm about markets such as eastern Europe,<sup>56</sup> many single country funds declined along with the general downward trend in the market.<sup>57</sup>

A key factor that may influence investor interest in new or existing closed-end companies is the recurring tendency of their shares to trade at a discount to net asset value. In general, discounts appear shortly after initial public offerings and affect all types of publicly traded closed-end companies, although to varying degrees. A 1989 study by the Commission's Office of Economic Analysis of the post-offering price performance of closed-end companies found that, on average, closed-end companies lost significant value during the first 120 trading days following their initial public offerings. After twenty-four weeks, the average discount for closed-end United States equity funds was 10.019%. For closed-end foreign stock funds, the discount was 11.424%. The average discount for closed-end bond funds was much lower, only 0.012%.<sup>58</sup>

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<sup>56</sup>See John Waggoner, *Closed-End Funds Wither in Europe*, USA TODAY, Feb. 13, 1991, at 3B.

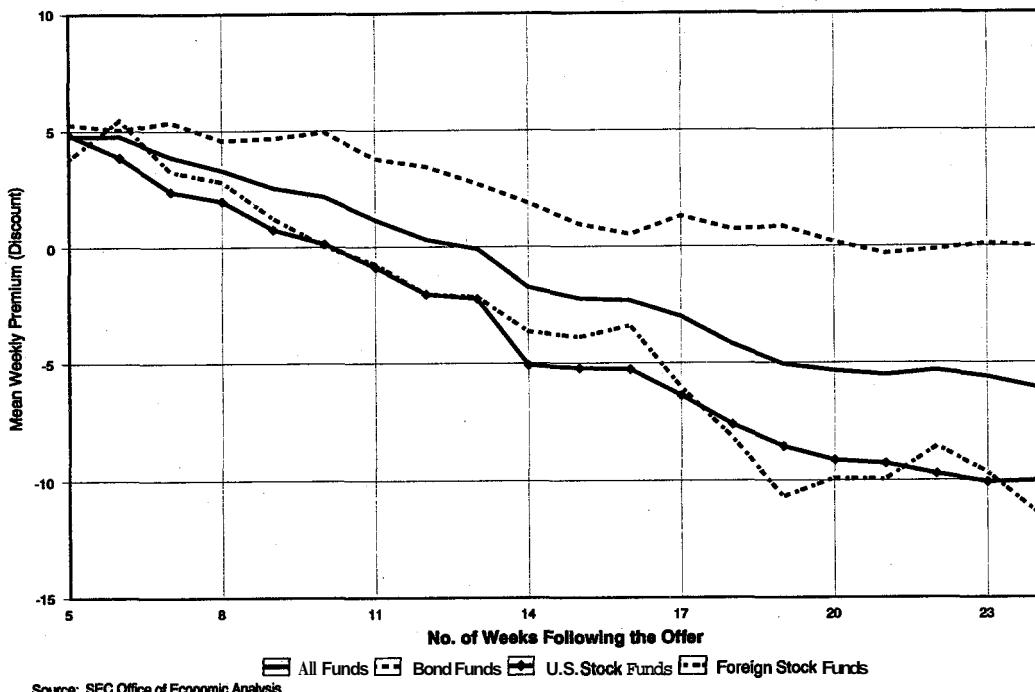
<sup>57</sup>See Roger Lowenstein, *Mexico Funds' Deep Discount May Be Bargain*, WALL ST. J., Oct. 18, 1990, at C1 (discussing the general decline in prices of country fund shares). In the market generally, for the year ended January 2, 1991, Standard & Poor's 500 Composite Stock Price Index declined by 9.0%, the Dow Jones Industrial Average by 7.1%, and the Russell 2000 index of small companies by 22.9%. *Investment Figures of the Week*, BUS. WK, Jan. 14, 1991, at 143.

The dramatic slump in share prices forced managers to try various methods to reverse this trend. See Carole Gould, *Hunting the Closed-End Conversion*, N.Y. TIMES, Aug. 26, 1990, at 18F; Deborah Hargreaves, *Euro-Spain Fund May Buy Back Its Shares*, FIN. TIMES, Sep. 27, 1990, at 23; Jonathan Clements, *Public Funds Are Facing Some 'Raiders' They Might Like: Their Own Managers*, WALL ST. J., Dec. 11, 1990, at C1. The methods currently being used by closed-end companies to reduce discounts are discussed in the text below.

<sup>58</sup>See Office of Economic Analysis, SEC, THE POST-OFFERING PRICE PERFORMANCE OF CLOSED-END FUNDS 4 (July 21, 1989) [hereinafter THE POST-OFFERING PRICE PERFORMANCE OF CLOSEDEND FUNDS].

FIGURE 11-1

## Premiums and Discounts from NAV for IPOs of Closed-End Funds



Source: SEC Office of Economic Analysis

A popular theory advanced to explain the discount is that market interest in closed-end companies falls significantly after the initial public offering, mainly because brokers are paid low commissions for secondary trades<sup>59</sup> and because, until recently, few market analysts have followed closed-end companies on a regular basis.<sup>60</sup> Brokerage houses have begun hiring closed-end company analysts, however, and there is evidence that brokers are recommending purchases of closed-end company shares (at least in the secondary market) to

<sup>59</sup> BURTON G. MALKIEL, *A RANDOM WALK DOWN WALL STREET* at 261-62 (Rev. ed., 1975); BENJAMIN GRAHAM, *THE INTELLIGENT INVESTOR* at 126 (4th rev. ed., 1973).

<sup>60</sup> Another analysis argues that "the closed-end fund discount, the rate at which initial public offerings are made, and the relative valuation of small stocks [are all] driven by changes in the sentiment of the small investors." Under this view, "[t]he closed-end discount thus serves as a thermometer of small-investor sentiment -- of their overoptimism or overessimism." J. Bradford De Long & Andrei Shleifer, *Closed-End Fund Discounts: A Yardstick of Small-Investor Sentiment*, 18 J. PORTFOLIO MANAGEMENT, No. 2, 46 (Winter 1992).

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retail investors?" Perhaps as a result of this increased interest, discounts narrowed during 1991.

Whatever the cause of discounts, the initial investors in closed-end companies may be affected more than the initial participants of other securities products. In part, selling fees may be higher with closed-end offerings than with other initial public offerings.<sup>62</sup> Often investors in closed-end offerings do not realize that part of their investment will go to finance the offering, so that their shares will automatically have a lower net asset value than the amount of their initial investment.<sup>63</sup> If those investors have no choice but to sell their shares in the secondary market at a discount, they consequently suffer a loss of capital. For this reason, seasoned investors avoid purchasing during initial offerings and wait for discounts to appear in the secondary market before buying shares.<sup>64</sup>

### C. Methods For Reducing Discounts

Market discounts are a frequent source of concern for many closed-end company managers and sponsors. As a result, sponsors have considered and used a variety of techniques for responding to discounts or attempting to forestall them.

Approaches to curing market discounts have met with varying degrees of success. For example, some companies use leverage to borrow cash equal to the underwriting discount paid to brokers, and invest that amount in the company. The theory behind this practice is that discounts result from the company being worth less than the investors' initial investment.<sup>65</sup> Of course, the benefit of added earnings potential from increasing the assets invested in the company is countered by the increased risk of leverage.

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<sup>61</sup>See Jonathan Clements, *Slim Pickings Among Closed-End Funds*, WALL ST. J., Mar. 8, 1991, at C1.

<sup>62</sup>THE POST-OFFERING PRICE PERFORMANCE OF CLOSED-END FUNDS, *supra* note 58, at 23.

<sup>63</sup>Proposed revisions to Form N-2, the registration form used by closed-end companies, would re-label underwriting discount as "sales load" in the per share table to increase investors' understanding of this charge. Registration Form for Closed-end Management Investment Companies, Investment Company Act Release No. 17091, section III.B. (July 28, 1989), 54 FR 32993 (proposed amendments to Form N-2 and guidelines).

<sup>64</sup>See, e.g. Marsha Meyer, *The Savvy Way to Buy Closed-End Funds*, MONEY, Sept. 1987, at 153, 154; Jonathan Clements, *In Aftermath of Stocks' Sell-Off, Some Advocate Closed-End Funds*, WALL ST. J., Aug. 22, 1990, at C1; Richard Phalon, *Duck Shoot*, FORBES, Sept. 3, 1990, at 165.

<sup>65</sup>See *supra* note 63 and accompanying text.

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Some companies offer dividend reinvestment plans, under which the company reinvests shareholder dividends and distributions in additional shares that are issued by the company at the lower of market value or net asset value. Similarly, some companies engage in rights offerings, which are strictly limited by the Act.<sup>66</sup> While these practices appear to counteract the tendency toward discounts, dilution occurs when shareholders exercise rights or purchase new shares at prices less than net asset value. This eventually may cause a corresponding downward adjustment in the market price.

Finally, some companies offer a variation on the dividend reinvestment plan that includes a "cash purchase" feature through which shareholders may authorize an independent agent to purchase shares in the market whenever the market price is less than net asset value. While these purchases are made by existing shareholders, and not the company, they act in the same way as repurchases by the company on the open market in reducing discounts.

One method of ending discounts is to convert from closed-end to open-end status, but this approach has significant drawbacks. Conversion radically changes how a closed-end company may operate. The company's investment strategy may have to be re-evaluated; there are expenses and potential losses associated with restructuring a portfolio to increase its liquidity to match that of open-end companies; and leverage and capital structure may have to be adjusted. In addition, and perhaps most importantly, the former closed-end company has to develop a relationship with a distributor and comply with the more rigorous pricing, distribution, and redemption requirements that apply to open-end companies. Thus, for many closed-end companies, conversion from closed-end to open-end status has significant drawbacks.

Even the potential for elimination of discounts upon conversion can affect a closed-end company. Discounts attract arbitrageurs who gamble on swings in the discount and "raiders" or others who attempt to take over the company, sometimes forcing proxy contests to cause a company to convert from closed-end to open-end status.<sup>67</sup> As a result, potential targets have adopted supermajority

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<sup>66</sup>Under section 23, closed-end companies may issue warrants or rights exercisable at less than net asset value as provided by section 18(d). Section 18(d) requires warrants and rights to be issued exclusively to existing shareholders and to expire within 120 days of their issuance.

<sup>67</sup>Upon conversion to open-end status, all shareholders may redeem shares at net asset value. Thus, raiders would instantly realize any profit on the difference between the discount prices they paid for the closed-end shares and the net asset value they are entitled to receive for the open-end shares. See, e.g., Gould, *Hunting the Closed-End Conversion*, *supra* note 57, and Phalon, *Duck Shoot*, *supra* note 64.

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voting provisions that make it nearly impossible for conversions to succeed.<sup>68</sup> In addition, to pre-empt the threat of forced takeovers, sponsors have organized closed-end companies that automatically will seek to convert to open-end status under certain circumstances, or after a fixed period of time.<sup>69</sup> While these provisions are intended primarily as anti-takeover tactics, they may actually minimize discounts, particularly as a shareholder vote approaches.<sup>70</sup>

For many closed-end companies, a more reasonable alternative for reducing discounts may be to repurchase shares under the limited circumstances provided by section 23(c) of the Act and rules 23c-1 and 23c-2 thereunder.<sup>71</sup> Under section 23(c)(1), closed-end companies may purchase shares on a securities exchange and such other open market as the Commission by rule designates, provided that the company has notified stockholders of its intention within the preceding six months (if such securities are stock). Rule 23c-1 permits purchases on other open markets subject to a number of additional provisions designed to protect shareholders.<sup>72</sup> Rule 23c-2 permits closed-end companies to call or redeem securities according to their terms, under certain conditions.<sup>73</sup> Such

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<sup>68</sup>Section 13(a)(1) of the Act requires a majority of a company's outstanding voting securities to authorize a change in subclassification from closed-end to open-end. 15 U.S.C. § 80a-13(a)(1). A typical supermajority voting provision requires at least a two-thirds (but usually not over three-fourths) vote in favor of conversion. See Mary Joan Hoene, *Closed End Funds - Discount and Takeover Issues*, 1990 MUTUAL FUNDS AND INVESTMENT MANAGEMENT CONFERENCE at IX-95.

<sup>69</sup>The conversion is contingent, of course, on obtaining the necessary shareholder approval required by section 13(a) of the Act. The shareholder vote usually may take place only several years after the fund's inception, and may hinge on a specific level of discount appearing or continuing for a specified period of time. See, e.g., *id.* at IX-98.

<sup>70</sup>See Gregory A. Brauer, 'Open-Ending' Closed-End Funds, 13 J. FIN. ECON., 491,506-07 (1984) (examining the effect on secondary market prices of closed-end companies' announcements of proposed conversions to open-end status). But see THE POST-OFFER PRICE PERFORMANCE OF CLOSED-END FUNDS, *supra* note 58, at 18-19, 36 (an examination of a sample of 64 closed-end companies 24 weeks after their initial public offering showed that there was a statistically insignificant difference in the discount or premium between companies with anti-takeover provisions and those without, and that the results did not change when the sample was broken down by type of fund).

<sup>71</sup>17 C.F.R. §§ 270.23~-1,23c-2.

<sup>72</sup>Among other things, the rule generally requires that purchases of junior shares not disturb the asset coverage requirements of section 18, that purchases not be from affiliated persons of the issuer, and that purchases be made at a price not exceeding the lower of the market value, if any, or the net asset value of the security at the time of purchase.

<sup>73</sup>Rule 23c-2(a) generally permits a registered closed-end company to call or redeem its shares in accordance with the terms of such securities or the company's charter; this rule has been (continued..)

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repurchases can create some market activity that may reduce the discount, but those rules do not facilitate transactions such as periodic direct repurchase offers by closed-end companies.

Under section 23(c)(2), closed-end companies may repurchase shares directly from shareholders by conducting issuer tender offers, after reasonable opportunity to submit tenders is given to all holders of securities of the class to be purchased. In addition, section 23(c)(3) provides the Commission with rulemaking authority to provide other means for closed-end companies to repurchase their shares in a manner that does not unfairly discriminate against any holders of the securities being repurchased.

#### **D. Closed-End Tender Offers**

Certain closed-end companies have avoided discounts entirely while still remaining closed-end by making periodic tender offers at net asset value under section 23(c)(2). With one exception, these companies' shares have not been traded in the market,<sup>74</sup> and the companies have provided shareholder liquidity solely through quarterly tender offers.

The first closed-end companies to use this procedure were loan participation or "prime rate" funds. These companies, first introduced in 1988, invest primarily in illiquid assets consisting of interests in senior, secured

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<sup>73</sup>(...continued)

interpreted as permitting calls and redemptions solely at the issuer's option and without any choice on the part of the shareholder. Dimensional Fund Advisors, Inc. (pub. avail. Nov. 21, 1988).

<sup>74</sup>As a condition to exemptive relief from rule 10b-6 under the Exchange Act (17 CFR § 240.10b-6), closed-end companies that intend to make such repurchases may not list their shares on a securities exchange or have their shares quoted on the National Association of Securities Dealers Automated Quotation system. Moreover, due to the similarities between open-end companies and closed-end companies making continuous offerings and periodic repurchases, United States securities exchanges might not permit the shares of such funds to be listed. Securities exchanges in the United States generally do not list redeemable securities. For example, staff of the New York Stock Exchange have advised us in discussions that the exchange's policy is to begin de-listing proceedings if a listed closed-end company converts to open-end status. Recently, however, the American Stock Exchange ("AMEX") has participated in the development of at least one complex synthetic securities product that includes redeemable securities intended to trade on AMEX. See SuperTrust Trust for Capital Market Fund, Inc. Shares, Investment Company Act Release Nos. 17613 (Jul. 25, 1990), 55 FR 31281 (Notice of Application) and 17809 (Oct. 19, 1990), 47 SEC Docket 1098 (Order).

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corporate loans that have floating interest rates.<sup>75</sup> Although loan participation funds register as closed-end companies, they operate much like open-end companies, offering shares continuously and providing the sole source of liquidity for their shareholders. While only five loan participation funds have registered with the Commission, they have been successful in attracting investors! As of December 31, 1991, the loan participation funds had total assets of almost \$6 billion and accounted for approximately eight percent of the total assets held by closed-end companies.<sup>76</sup>

By the end of 1991, two other closed-end companies had followed the lead of the loan participation funds and indicated that they would periodically consider making tender offers to their shareholders.<sup>77</sup> In early 1992, by contrast, one loan participation fund appeared to abandon the procedures. Pilgrim Prime Rate Trust announced that it would not make a repurchase tender offer and listed its shares on the New York Stock Exchange on March 9, 1992.<sup>78</sup> None of the other closed-end companies followed suit, and Pilgrim's shares traded on the exchange at a significant discount. Within two weeks after the beginning of exchange trading, Pilgrim announced a tender offer for nearly nine percent of its shares.<sup>79</sup>

Closed-end company repurchase offers are subject to a number of significant restrictions, however. Issuer tender offers must comply with the

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<sup>75</sup>The interest rates float or reset at a margin above a generally recognized base lending rate such as the prime rate quoted by a designated United States bank, the London InterBank Offered Rate, the average secondary market rate for large certificates of deposit, or other base lending rates used by commercial lenders.

<sup>76</sup>The five registrants are Allstate Prime Income Trust, Eaton Vance Prime Rate Reserves, Merrill Lynch Prime Fund, Pilgrim Prime Rate Trust, and Van Kampen Merritt Prime Rate Income Trust.

<sup>77</sup>Lipper Analytical Securities Corp., Lipper Closed-End Performance Analysis Service, Jan. 31, 1992, at 44 (assets of \$5.80 billion out of total closed-end fund assets of \$72.76 billion). But see Randall W. Forsyth, *Nut Necessarily Prime Time*, BARRON'S, Oct. 21, 1991, at 47 (indicating that investors tendered their shares at significant levels beginning in mid-1991 as interest rates dropped).

<sup>78</sup>Merrill Lynch High Income Municipal Bond Fund, Inc., and Emerging Markets Growth Fund, Inc. The latter, however, has not made any tender offer since January, 1991.

<sup>79</sup>Jonathan Clements, *Pilgrim Takes Fund Industry by Surprise*, WALL ST. J., Feb. 21, 1992, at C1 (quoting letter to shareholders from Palomba Weingarten, Chairman, Pilgrim Group).

<sup>80</sup>Jonathan Clements, *Pilgrim Prime Rate Plans Tender Offer for 9% of Shares*, WALL ST. J., Mar. 26, 1992, at B6.

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requirements of rules 13e-4<sup>81</sup> and 14e-1<sup>82</sup> under the Securities Exchange Act.<sup>83</sup> Moreover, they must obtain exemptive relief from the provisions of rule 10b-6 under the Exchange Act, which generally prohibits participants in a distribution from contemporaneously buying securities of the same class being distributed. They must conduct their offerings in compliance with rule 415<sup>84</sup> under the Securities Act,<sup>85</sup> which governs "shelf" registrations. As a result, tender offers generally are a relatively cumbersome and limited way for closed-end companies to provide for shareholder liquidity. They involve costs such as producing offering materials, notifying shareholders, and paying registration and filing fees. Open-end companies are not subject to similar requirements when redeeming their shares.

Tender offers also are subject to a number of qualifications that do not apply to redemptions of open-end shares. For example, tender offers generally are made for limited amounts of shares and, if more shares are tendered than the company is prepared to buy, the company is only required to accept them on a pro rata basis. A company also is not obligated to make a tender offer. Finally, these companies have not been able to provide investors with assurance the tender offers will take place. The Division has stated that committing in advance to make periodic tender offers might result in directors breaching their fiduciary duties to shareholders, since investors could not be certain when or if their shares would actually be repurchased by the company.<sup>86</sup> Accordingly, these companies' prospectuses represent that each quarter the board of directors will consider whether to make a tender offer for outstanding shares, but caution that tender offers may not take place every quarter.

The closed-end company repurchase offers illustrate clearly the difficulty experienced by sponsors wishing to offer an alternative procedure for shareholders to resell their shares. This chapter has described other examples of funds that do not fit comfortably within the strict open-end/closed-end system.

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<sup>81</sup>17 C.F.R. § 240.13e-4.

<sup>82</sup>17 C.F.R. § 240.14e-1.

<sup>83</sup>Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-78l1. These requirements are discussed in Section III.A.1, *infra*.

<sup>84</sup>17 C.F.R. § 230.415.

<sup>85</sup>Securities Act of 1933, 15 U.S.C. §§ 77a-77aa. Closed-end companies may continuously offer new shares in reliance on paragraph (a)(1)(ix) of rule 415, but paragraph (h) of the rule limits them to registering only the number of shares that they reasonably expect will be offered or sold within two years from the effective date of the registration statement.

<sup>86</sup>See Guide 2 to proposed amendments to Form N-2, Inv. Co. Act Rel. 17091, *supra* note 63.

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For example, some country funds appear capable of operating much like open-end companies but cannot because of the seven-day requirement for meeting redemptions. Certain closed-end funds appear interested in providing opportunities for shareholders to exchange their shares for net asset value, but have not been able to do so with any certainty and remain within the closed-end classification.

## 111. Recommendations

The Division believes it is appropriate to modernize the existing regulatory structure to permit the development of new investment companies that, while having characteristics of the current open-end and closed-end forms, would offer a degree of redeemability or "repurchase-ability" between the two traditional extremes. Accordingly, the Division recommends adoption of a rule under section 23(c) of the Act to facilitate periodic repurchases of closed-end shares. In addition, the Division recommends that the Commission propose a new exemptive rule under section 22 of the Act to establish requirements for a new type of open-end investment company (a "limited redemption investment company") that would invest in less liquid securities and provide shareholders with a limited right to redeem shares at net asset value. Finally, given the importance of portfolio liquidity to any investment company that redeems or repurchases its shares, the Division recommends the introduction of legislation enabling the Commission to specify liquidity standards appropriate to each form of investment company.

### A. Repurchase Offers by Closed-End Companies

In light of the problems raised by market discounts and the closed-end companies periodic tender offers responding to the discounts, the Division considered whether to recommend to the Commission that it facilitate direct share repurchases by closed-end companies. As discussed above, the only effective mechanism that has emerged for addressing the discounts is the direct repurchase approach that a small number of closed-end companies have made to their shareholders pursuant to section 23(c)(2) of the Investment Company Act and Exchange Act rules governing issuer tender offers.

In view of those companies' experience and the comments received in response to Commission's release soliciting comments on the regulation of investment companies,<sup>87</sup> the Division believes that it would be appropriate to

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<sup>87</sup>Study Release, *supra* note 52. Several commenters favored a mechanism for such repurchases. See, e.g., Letter from American Bar Association, Section of Business Law, Committee on Federal Regulation of Securities, 1940 Act Structured Finance Task Force, to Jonathan G. Katz, (continued..)

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provide a more defined, efficient mechanism for direct repurchase offers by closed-end companies. The Division therefore recommends that the Commission adopt rules under section 23(c) to permit closed-end companies to repurchase their shares at fixed intervals in accordance with appropriate safeguards for the protection of investors.<sup>88</sup>

While many companies and shareholders are interested in repurchases at net asset value, repurchase offers would not be appropriate or desirable for all closed-end companies. Some types of companies tend not to have discounts. Other companies invest in securities that are not liquid or easily marketable; the valuation of the assets of these companies may be so imprecise that it is difficult to ensure that repurchase prices would be fair to both tendering and remaining shareholders. In many cases, the portfolio management demands created by repurchases and new sales may be incompatible with a company's (and its shareholders') objective of remaining fully invested in securities.<sup>89</sup> Accordingly, we do not propose that any repurchase rule be mandatory for all closed-end

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<sup>87</sup>(...continued)

Secretary, SEC (Oct. 16, 1990), File No. **S7-11-90** [hereinafter ABA Comment]; Letter from Davis, Polk & Wardwell, to Jonathan G. Katz, Secretary, SEC (Oct. 10, 1990), File No. **S7-11-90** [hereinafter Davis Polk Study Comment]; and Letter from Merrill Lynch & Co., Inc. to Jonathan G. Katz, Secretary, SEC (Oct. 18, 1990), File No. **S7-11-90** [hereinafter Merrill Lynch Study Comment].

<sup>88</sup>This recommendation represents a change from the prior position that an advance commitment to repurchase may be inconsistent with the fiduciary duties of the company's board of directors to consider the merits of the proposed repurchase based on the circumstances *at the time* the repurchase is made. Inv. Co. Act Rel. **17091**, *supra* note 63. While the Division continues to believe that the directors of a closed-end company have a fiduciary duty to consider the appropriateness of share repurchases, this fiduciary duty should not preclude a closed-end company from making an advance commitment to periodic repurchases. This duty would include reviewing a company's portfolio management and borrowing procedures to ensure that the company can meet its repurchase commitments.

The proposed repurchase procedures would address many of the underlying concerns of the Division's prior position, as would the proposed requirement that closed-end companies making repurchases disclose possible limitations on repurchases and possible effects on portfolio management of the need to plan for repurchases. Moreover, the adoption of an express liquidity standard and of limitations on the use of leverage by closed-end companies making repurchases should address concerns about a company's ability to manage its portfolio so as to meet its repurchase commitments.

<sup>89</sup>See, e.g., General American Study Comment, *supra* note 52, at 2-6; Baker, Fentress Study Comment, *supra* note 52, at 2-5 (both of which opposed any procedure for such repurchases).

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companies. Rather, any rule should provide a safe harbor within which each company could elect to offer the repurchase feature.<sup>90</sup>

It is unclear whether there would be a demand for such closed-end repurchase procedures if the Commission also adopts rules permitting limited redemptions by open-end companies; many investment companies that would wish to provide shareholder liquidity might prefer to operate as limited redemption open-end companies rather than as closed-end companies making periodic repurchase offers. Ultimately, if both options are available, sponsors and investors will determine which options works best for a particular fund.

## **1. Operational Procedures for Repurchases**

Periodic repurchases raise a number of operational issues. To address those issues, the discussion below recommends including specific operational requirements in rules authorizing periodic repurchases. The Division has examined the experience of certain companies (mainly the loan participation funds) that currently make periodic tender offers to repurchase their shares. Following that model, the basic steps of the process are the following: (i) a fund makes a repurchase offer to shareholders; (ii) during the tender offer period that follows, shareholders may tender their shares and withdraw their tenders until the termination of that period (the "cut-off date"); (iii) by the cut-off date the fund determines whether to accept or reject tenders; and (iv) the fund makes payment promptly thereafter. The experience of the closed-end companies that have made periodic repurchase offers raises a number of questions, which we explore below, and suggests that it would be appropriate to modify the procedures used by those companies.

### **a. Relationship to Tender Offer Rules**

Currently, closed-end companies that make periodic repurchases do so via tender offers. In many respects, the tender offer rules under sections **13** and **14** of the Exchange Act<sup>91</sup> address important investor protection concerns relating to repurchases by closed-end companies. In other respects, however, the experiences of closed-end companies that have conducted repurchases in accordance with the tender offer rules suggest that some provisions of those rules were intended to apply to different transactions and do not achieve their

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<sup>90</sup>Such a rule could be promulgated under section 23(c)(3), which expressly authorizes the Commission to issue rules, regulations and orders defining other circumstances in which repurchases may be made. Alternately (or in addition), the rule could be promulgated under section 23(c)(2) as a safe harbor within which an offer would be deemed to provide "reasonable opportunity to submit tenders given to all holders of securities of the class to be purchased."

<sup>91</sup>15 U.S.C. §§ 78m, 78n.

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objectives when applied to closed-end companies conducting repurchases at a price based on net asset value. Accordingly, the Division recommends that rule 13e-4 be amended to exempt closed-end company periodic repurchases complying with a new rule under section 23(c) of the Act, and that the new rule under section 23(c) incorporate certain pertinent requirements of rule 13e-4 as adapted to address the unique investor protection concerns that are raised by closed-end company repurchase offers. The Division also recommends taking an analogous approach with respect to rule 14e-1, which prohibits certain tender offer practices. The following discussion examines some of the areas where specific adaptations for repurchasing closed-end companies may be appropriate.

### **b. Formulation of Repurchase Offers**

A key issue to be addressed by the proposed rules would be the procedure to be used by a company in determining the timing and extent of repurchase offers. Because this issue is of critical importance both in shareholders' investment decisions and in a company's ability to manage its portfolio, the Division recommends that the rule require repurchase offers to take place according to a fundamental policy that defines both the timing of repurchases and the minimum and maximum amount of shares to be repurchased under any offer. This approach would contrast with the current practice in closed-end company repurchase offers, where the amount to be repurchased is determined by the company with respect to each repurchase. At the same time, we recognize that, because of market conditions and considerations of portfolio management, it might be appropriate for a company to repurchase a greater or lesser amount in a given offer. For that reason, the Division also recommends that a company have authority to determine, pursuant to guidelines established by the company's board of directors, the amount of each repurchase offer within minimum and maximum limits set by fundamental policy.

**(1) Fundamental Policy.** The procedures governing closed-end redemption offers should be matters of fundamental policy, because shareholders should have maximum certainty about the timing and extent of purchases.<sup>92</sup> An irregular or sporadic repurchase program would cause confusion and might also provide opportunities for insider abuse and manipulation.<sup>93</sup>

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<sup>92</sup>Because the procedures would be fundamental, they could not be changed unless authorized by a majority vote of the shareholders. See Investment Company Act §§ 8(b)(3), 13(a)(3), 15 U.S.C. §§ 80a-8(b)(3), -13(a)(3).

<sup>93</sup>The rulemaking proceeding also could examine whether alternative requirements would provide sufficient investor protection. One alternative, which we do not favor, but which would continue the current practice of closed-end companies that have made periodic offers, would be to leave the full determination of the timing and amount of the offer to the board of directors, (continued..)

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**(2) Intervals between Repurchase Offers.** The Division believes that any rule should require a schedule for periodic repurchases at regular, fixed intervals. The interval should be regular and easily ascertained; for example, the rule could specify that permissible intervals are three months, six months, or a year. Such intervals reduce the potential for investor confusion and allow investors some ability to plan. From the range of permissible intervals specified in the rule, each company could select the frequency at which it would make repurchase offers as a matter of fundamental policy consistent with the company's investment objectives.

**(3) Minimum and Maximum Amounts of Repurchase Offers.** The Division believes that a company seeking to periodically repurchase its shares should be *required* to determine at the outset the minimum and maximum amount of shares that will be repurchased, either in absolute terms or as a percentage of shares outstanding. For example, a closed-end company could adopt a policy that provided for quarterly repurchases of between five and ten percent of the shares of common stock outstanding. Establishing a maximum repurchase amount would assist managers in judging the company's liquidity needs, while a minimum would assure shareholders that the company will in fact make repurchase offers at a sufficient level to accommodate shareholder liquidity needs.

**(4) Levels of Individual Repurchase Offers.** The Division recognizes that a company should have some flexibility to determine at the time of each repurchase offer the maximum amount of that offer. Currently, under rule 13e-4, an issuer may purchase "an additional amount of securities not to exceed two percent of the class of securities that is the subject of the tender offer;" beyond that point, the issuer must extend the tender offer for a specified period.<sup>94</sup> It would be appropriate for a closed-end company to have similar limited discretion to increase the amount if it determines that repurchasing a larger number of shares is appropriate.<sup>95</sup> The investment adviser would make these determinations pursuant to guidelines established by the company's board of directors. This discretion would allow the company to respond to portfolio

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<sup>93</sup>(...continued)

subject to a requirement of full disclosure and notice. Cf. rule 11a-3, 17 CFR. § 270.11a-3 (60 days' advance notice required before any change in the terms of a mutual fund's exchange offer).

<sup>94</sup>Rule 13e-4(f). Rule 14e-1(b) has a comparable provision.

<sup>95</sup>We recognize that allowing such discretion would necessarily reduce the amount of certainty associated with repurchases. In theory, a company could have a minimum schedule providing for small repurchase amounts, yet regularly accept more shares, possibly lulling investors into believing that the company will always buy back a significant number of shares. We believe, however, that clear disclosure of the minimum and maximum amounts of shares the company commits to repurchase would minimize the possibility for confusion and misleading practices.

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management concerns and any expectations of the level of shareholder tenders.<sup>96</sup> Of course, the amount of the repurchase offer could not be increased beyond the maximum limit set by fundamental policy.

**(5) Exceptions.** Finally, the Division also recognizes that it would be appropriate to allow closed-end companies to suspend scheduled repurchases in limited circumstances when repurchases would have severe consequences for shareholders. For example, in unusual circumstances, repurchases could affect a company's tax status as a regulated investment company under Subchapter M of the Internal Revenue Code.<sup>97</sup> In those circumstances, a company's board should be allowed to suspend or limit repurchases. Such circumstances currently are disclosed in prospectuses where tender offers are contemplated and in issuer tender offer documents.<sup>98</sup> Closed-end companies seeking to rely on the new rule similarly should be required to disclose these limitations in their prospectuses.

### c. Preparation of Disclosure Materials

Rule 13e-4 under the Exchange Act requires an issuer to provide a statement containing extensive disclosure. Among other items, the statement must disclose the source and amount of the consideration to be paid, the purpose of the tender offer, transactions in the issuer's securities by certain related persons, and any arrangements relating to the tender offer. These requirements can impose significant costs and delays on closed-end companies and their shareholders in the preparation, printing, and distribution of the statements.

Much of the current tender offer disclosure requirements would not be relevant to periodic repurchase offers by closed-end companies under the proposed rule. Since the essential purpose would be simply to remind shareholders of the previously disclosed opportunity to have shares repurchased at net asset value, lengthy, detailed disclosure would not be necessary. Investors in such closed-end companies would already know the general terms and

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<sup>96</sup>Pursuant to their fiduciary obligations to shareholders, the directors would monitor the repurchase process and serve as a check on proposals by the investment adviser that repurchase offers consistently be made in the minimum amount, since such proposals might serve primarily the adviser's interest by maximizing the level of assets under management on which advisory fees would be paid. On this and other points, the Division expects that the consideration of any proposed rule will examine what role, if any, the independent directors should have.

<sup>97</sup>26 U.S.C. §§ 851-860.

<sup>98</sup>See, e.g., Pilgrim Prime Rate Trust, Offer to Purchase at 5-6 (Aug. 2, 1991), reprinted in **Pilgrim** Prime Rate Trust, Schedule 13E-4, Exhibit (a)(1)(ii) (Aug. 2, 1991); Merrill Lynch Prime Fund, Inc., Offer to Purchase at 5-6 (Aug. 19, 1991), reprinted in Merrill Lynch Prime Fund, Inc., Schedule 13E-4, Exhibit (a)(1)(ii) (Aug. 19, 1991).

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purposes of such offers from prospectus disclosure -- indeed, this procedure might be a material factor in most investors' decisions to purchase shares of such closed-end companies. Thus, at the time of each repurchase offer, investors would need to receive only basic disclosure concerning the procedures for tendering their shares for repurchase. For example, first, they would need some reminder of the existence and timing of the repurchase offer. Second, they would need to know the amount to be repurchased in a given offering; if the company has discretion to set the amount of the offering, the statement should disclose any material factors pertinent to the determination of the amount. Third, basic information about net asset value also would be appropriate, including the net asset value as of the date of the repurchase offer and information about means for shareholders to learn net asset value at subsequent points (such as references to newspaper publication or any telephone information systems).<sup>99</sup> Accordingly, the Division recommends that a repurchase offer rule require closed-end companies making periodic repurchases to provide shareholder notification containing the basic information outlined above.

#### **d. Timing of Repurchase Offer Events**

The determination of the relative timing of key events in the repurchase process raises several questions. First, how far in advance should the company provide notice to shareholders of each repurchase offer? For issuer tender offers, rule 13e-4(f) requires that a tender offer remain open for "(i) at least twenty business days from its commencement; and (ii) at least ten business days from the date" of notice of certain changes in the offer.<sup>100</sup> Less advance notice may be necessary with periodic repurchase offers than with most issuer tender offers, since under most circumstances shareholders would not need to consider any pertinent extraordinary corporate events or the relation of the offer price to a market price. Instead, the chief concern would be to ensure that shareholders receive enough advance notice to decide whether they want to tender their shares and can return their tender forms to the company by the date of the termination of the repurchase offer. It may be appropriate for the length of the notice period to vary depending on the frequency of repurchase offers: investors may need more advance notice if a company makes repurchase offers annually rather than quarterly.

Second, should there be a mandated minimum or maximum interval between the date by which shareholders must tender shares (the cut-off date) and the date **by** which the company makes payment, and, if so, how long should the interval be? Certainly some advance notice would be necessary to provide

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<sup>99</sup>Cf. Guide 2 to proposed revisions to Form N-2, Inv. Co. Act Rel. 17091, supra note 63.

<sup>100</sup>See also rule 14e-1(a), (b).

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enough time for the portfolio manager to adjust the portfolio without depressing the value of portfolio securities, but the length of time may vary depending on the liquidity of a given company's portfolio. Commenters have suggested a range of intervals, generally between thirty and sixty days;<sup>101</sup> that range suggests that it may be appropriate to leave companies some flexibility to set the terms of repurchase offers. Currently, repurchases made as issuer tender offers are subject to a requirement of "prompt" payment; the rules do not expressly mandate a period for payment but the Commission generally has interpreted the term "prompt" as requiring payment within five business days.<sup>102</sup>

Third, when should the repurchase price be calculated? Currently, closed-end companies making tender offers repurchase their shares at the net asset value calculated as of the close of business on the date on which the offer expires, but certain factors raise questions whether that is the most appropriate date for determining net asset value. Pricing shares at or near tender would allow shareholders who tender their shares to "lock in" their prices. Thus, they would not participate either in future losses experienced by other shareholders, or in any potential gains. If, however, exiting shareholders receive repurchase proceeds based on asset valuations calculated before the actual sales take place, remaining

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<sup>101</sup>See, e.g., ABA Comment, *supra* note 87, at 22 (30 to 60 days); Davis Polk Study Comment, *supra* note 87 (30 days); Merrill Lynch Study Comment, *supra* note 87 (not more than 60 days). See also Letter from Ronald L. Gallatin, Managing Director, Shearson Lehman Hutton, to Richard Ketchum, Director, Division of Market Regulation, SEC (Oct. 18, 1989) (suggesting that 21 days would be sufficient, including 14 days between the cut-off date and the valuation date, and seven days between valuation and payment). Mr. Gallatin provided the following diagram illustrating his proposed schedule for repurchases:

Notice Period	Regular Way Sale of Securities by Fund	Valuation Date	Payment Date
Day -14	Day 0	Day 14	Day 21

<sup>102</sup>The Commission has stated that there is not a single standard for what constitutes prompt payment under rules 14e-1 and 13e-4:

The Commission recognizes that the operation of this standard will be affected by the practices of the financial community and the following factors: current settlement, handling and delivery procedures relating to tenders made by guaranteed deliveries by appropriate institutions; procedures to cure technical defects in tenders; and the application of the Hart-Scott-Rodino Antitrust Improvement Act of 1976 and the rules promulgated thereunder.

Tender Offers, Exchange Act Release No. 16384, at text accompanying nn 34-35 (Nov. 29, 1979), 44 FR 70326, 70337 (adoption of amendments to tender offer rules). For the interpretation that "prompt" payment generally requires payment within five business days, see *id.* at n.36.

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shareholders' holdings may be diluted if it turns out that the assets sold did not garner the proceeds predicted for them at the time of pricing.

Alternatively, if shares are priced closer to the date of payment, there is a more accurate match between the price paid for repurchased shares and amounts realized upon disposition of portfolio securities sold to pay repurchase proceeds. In addition, shares that are tendered participate proportionally in the company's gains and losses during the payout period. On the other hand, shareholders who tender their shares for repurchase would assume the risk of market changes for extended periods after they have tendered their shares.<sup>103</sup>

Certain of those factors may assume greater weight to the extent that closed-end portfolios include securities that are less liquid or have less reliable valuations. To that extent, there is a greater risk that the amount realized upon disposition to meet redemptions might differ significantly from the amount estimated in calculating net asset value at the time of tender by shareholders. On the other hand, this risk may be reduced by requiring that a company already have sufficient liquid assets to meet its repurchase commitment by the time a repurchase offer is made.

#### e. Repurchase and Offering Price

The Division recommends that any rule for closed-end repurchase offers should require the repurchase price to be based on net asset value. This requirement would be consistent with the current practice of closed-end company periodic tender offers, which offer to repurchase shares at a price based on net asset value.<sup>104</sup> Moreover, the basic rationale for the Commission's allowance of closed-end company share repurchases is to provide a mechanism for shareholder liquidity at net asset value.

The requirement to base the repurchase price on net asset value need not preclude the imposition of certain charges on redemption. First, the rulemaking should address whether closed-end companies making repurchase offers may

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<sup>103</sup>The rule would require forward pricing, that is, pricing *after* shareholders have tendered their shares.

<sup>104</sup>See, e.g., Pilgrim Prime Rate Trust, Offer to Purchase, *supra* note 98, at 1. The use of net asset value has departed from traditional practice in other issuer tender offers. First, tender offers generally must state a fixed dollar amount for the price offered because schedule 13E-4 in Item 1(b) requires the issuer to state "the exact amount of such securities being sought and the consideration being offered therefor." For most portfolios, stating a dollar amount would not be possible if the offer is to be made at net asset value. But see, e.g., Baldwin Securities Corporation (pub. avail. Dec. 24, 1986) (exemption granted for tender offer by closed-end company where consideration would be adjusted net asset value).

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impose distribution charges comparable to contingent deferred sales loads,<sup>105</sup> currently, some closed-end companies making repurchase tender offers impose comparable early withdrawal charges. The rulemaking also should consider the appropriate treatment of exchanges into or from affiliated investment companies. Similarly, a net asset value requirement need not preclude companies from charging any scheduled fee reasonably necessary to compensate the investment company for the costs incurred in disposing of portfolio securities to generate cash to pay for repurchases.<sup>106</sup>

Likewise, the price of shares sold by closed-end companies making periodic repurchases should be based on net asset value. Such a requirement is necessary to comply with section 23(b), which generally prohibits closed-end companies from offering shares at prices below net asset value. Section 23(b) safeguards shareholders against dilution that would occur if subsequent purchasers were to buy shares at prices lower than the asset value of shares held by existing shareholders. This requirement coupled with those relating to the determination of the repurchase price, should preclude manipulation of the price of the company's shares and avoid a number of the abuses noted in the Investment Trust Study.<sup>107</sup>

If closed-end companies are to base their repurchase and offering prices on net asset value, they should calculate net asset value on a regular basis, perhaps linked to the periodicity of the repurchase offers. While rule 22c-1 requires open-end funds to determine net asset value every business day, closed-end companies are not required to price their shares more often than quarterly (for reporting purposes). Many closed-end companies, however, do voluntarily calculate and publish net asset values weekly.<sup>108</sup>

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<sup>105</sup>A related issue would be whether to permit closed-end companies to vary scheduled deferred charges for certain classes of shareholders as open-end companies may do with front-end loads under rule 22d-1, 17 CFR. § 270.22d-1. For closed-end companies making issuer tender offers, rule 13e-4 originally was interpreted as prohibiting variation in early withdrawal charges (comparable to contingent deferred sales loads). See Michael Berenson, *The Experience of Loan Participation Funds -- Insights for the 1990s*, 1990 MUTUAL FUNDS AND INVESTMENT MANAGEMENT CONFERENCE, at IX-12 to IX-13. The "best price" rule (rule 13e-4(f)(8)) requires that "the consideration paid to any security holder pursuant to the tender offer is the highest consideration paid to any security holder during such tender offer."

<sup>106</sup>Open-end companies may impose similar redemption fees. See Offers of Exchange Involving Registered Open-End Companies, Investment Company Act Release No. 17097, at n.37 (Aug. 3, 1989), 54 FR 35177 (adopting rule 11a-3).

<sup>107</sup>See *supra* Section II.A.1.

<sup>108</sup>Net asset values compiled by Lipper Analytical Services and the ICI appear each week in *Barron's*. Weekly listings also appear in the *Wall Street Journal* every Monday.

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## **2. Repurchase Offer Filing Costs**

Under rule 13e-4, in preparing and filing tender offer materials with the Commission, closed-end issuers incur costs that open-end companies do not bear. For loan participation funds that make tender offers every quarter, filing fees can become a significant expense.<sup>109</sup> To minimize the filing fee, closed-end issuers file tender offers for less than the total of their outstanding shares, then stand prepared to extend the tender offer if shareholders tender more shares than the registered amount. The practical effect of the fee requirement is that closed-end companies must pay one fee to register shares and a second to repurchase them. While the same requirement applies to non-investment company issuers, tender offers typically are extraordinary events for those issuers. By contrast, under the proposed repurchase procedures, closed-end companies would be unique because they alone would make periodic repurchase offers as a means of providing shareholder liquidity.

Closed-end company periodic repurchases would not be subject to those filing requirements, if the Commission exempts closed-end companies making periodic repurchases from rule 13e-4, as recommended above.

## **3. Offerings by Closed-End Companies**

Closed-end companies conducting periodic repurchases may need to raise additional equity. Otherwise, as their equity shrinks, their expense ratios will rise, harming their investment return. Moreover, an inflow of new capital can give a company greater flexibility in managing its portfolio by reducing the pressure to sell portfolio securities to meet repurchases. As discussed above, several closed-end companies that make periodic repurchases also conduct continuous offerings of their shares. These companies register their shares under rule 415(a)(1)(ix) under the Securities Act, which permits a continuous offering provided that the offering begins promptly and lasts more than thirty days. Although this rule allows continuous offerings to take place, it is an imperfect mechanism. The rule does not contemplate periodic offerings, although at least one closed-end company has agreed to abstain from offering or selling its shares during certain brief periods as a condition of exemption from rule 10b-6 (discussed below).<sup>110</sup> A closed-end company registered under this section also may have to halt continuous offerings temporarily, if, for example, material

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<sup>109</sup>Filing fees for tender offers under rule 13e-4 are calculated at a rate equal to 1/50th of one percent of the amount to be purchased.

<sup>110</sup>Merrill Lynch High Income Municipal Bond Fund, Inc. (Oct. 26, 1990).

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changes occur that require it to file an amendment to the registration statement?"'

Closed-end companies cannot qualify for rule 415(a)(1)(x), which allows *continuous or* delayed offerings by registrants that register on Form S-3 or Form F-3 (the so-called "short form registrations") because closed-end companies are not eligible to use those registration forms. But for this problem, rule 415(a)(1)(x) would provide a convenient method for closed-end companies to plan to make intermittent, rather than continuous, offerings. Such an ability would allow closed-end companies to coordinate the timing and amount of repurchases and sales, thus facilitating greater control over portfolio management.

Accordingly, the Division recommends that the Commission amend rule 415 to provide express authorization for closed-end companies making periodic repurchase offers to make delayed or continuous offerings.<sup>112</sup> As an alternative, it might be appropriate to impose on closed-end companies registration requirements comparable to those applicable to open-end funds, separate accounts, or unit investment trusts under rules 485,486, and 487 of the Securities Act.<sup>113</sup> Such a procedure would expedite the filing by closed-end companies of amendments for the purpose of updating financial statements.

#### **4. Rule lob-6**

If a closed-end company offers shares continuously, it currently cannot conduct tender offers without exemptive relief from rule lob-6 under the Exchange Act. Rule lob-6 generally prohibits persons involved in a securities offering from purchasing shares until after their participation in the offering is complete.<sup>114</sup> The rule's purpose is to prevent persons interested in the

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<sup>112</sup>This is the practice of a limited number of venture capital business development companies structured as closed-end limited partnerships that hold multiple closings, typically when the companies are making a significant investment, such as in connection with "mezzanine financing" of friendly leveraged acquisitions and similar transactions. Each time these issuers make a material investment, they halt sales until they file a post-effective amendment to their registration statement and updated disclosure becomes available.

<sup>113</sup>See Merrill Lynch Study Comment, *supra* note 87, at 111-9.

<sup>114</sup>17 C.F.R. §§ 230.485, .486, .487.

<sup>114</sup>The provisions of rule **lob-6** do not apply to redeemable securities issued by an open-end investment company. See rule 10b-6(d).

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distribution from "artificially conditioning the market for the securities in order to facilitate the distribution."<sup>115</sup>

In light of rule lob-6, closed-end companies seeking to periodically repurchase their shares are faced with the choice of either seeking exemptive relief or interrupting their continuous offerings so that the rule does not apply. Neither alternative is entirely satisfactory. Obtaining exemptive relief from rule lob-6 imposes additional costs and delays. Interrupting an offering also is problematic, since rule 415 does not permit closed-end companies to conduct periodic offerings. Each closed-end company that makes periodic repurchases has obtained an exemption from the prohibitions of rule lob-6. These exemptions are subject to requirements designed to prevent manipulation, including a requirement that there be no secondary market for the company's shares.<sup>116</sup>

The Division recommends that the Commission exempt closed-end companies making repurchase offers from rule lob-6, thus building upon the exemptions previously granted.<sup>117</sup> These repurchases would not involve any potential for "artificially conditioning the market for the securities"-- the primary abuse that rule lob-6 was intended to prevent.<sup>118</sup> The Commission has stated that rule lob-6 was "designed to protect the integrity of the securities trading market as an independent pricing mechanism. . ."<sup>119</sup> For investment companies, however, net asset value provides an independent pricing mechanism

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<sup>115</sup>Prohibition Against Trading by Persons Interested in a Distribution, Exchange Act Release No. 24003, section I (Jan. 16, 1987), 52 FR 2994 (adopting amendments to rule lob-6).

<sup>116</sup>Pilgrim Prime Rate Trust (Aug. 23, 1988), Eaton Vance Prime Rate Reserves (July 14, 1989), Van Kampen Merritt Prime Rate Income Trust (Sept. 27, 1989), Merrill Lynch Prime Fund (Oct. 24, 1989), and Allstate Prime Income Trust (Nov. 21, 1989). See also Emerging Markets Growth Fund, Inc. (Aug. 13, 1991), and Merrill Lynch High Income Municipal Bond Fund, Inc., *supra* note 110. The two latter exemptions involved additional requirements. First, neither the company, its principal underwriter, or any other broker-dealer may conduct any offers or sales of the company's shares during the last five business days of any tender offer. Second, the Merrill Lynch exemption provides that the company may not purchase any municipal bonds that are unrated, or are not considered investment grade, during the last five business days of any tender offer, except for bonds that are part of a new issue. We understand that this second requirement responds to concerns of the Division of Market Regulation that purchases of relatively illiquid portfolio securities might present the potential for manipulation of the price of securities held in the fund's portfolio and hence of net asset value.

<sup>117</sup>The rulemaking proceeding also should address the question of to what extent it would be appropriate to permit secondary market activity in the shares of closed-end companies making periodic repurchase offers.

<sup>118</sup>Exch. Act Rel. 24003, *supra* note 115.

<sup>119</sup>*Id.*, 52 FR at 2994.

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that distinguishes investment companies from all other issuers. This mechanism is based upon the values of the underlying portfolio assets and is not affected by the terms of a repurchase offer or of a distribution by an investment company. Accordingly, sales and repurchases at net asset value, properly computed, do not necessarily implicate the concerns of rule 10b-6, as evidenced by the rule's express exemption for redeemable securities issued by open-end companies. The policies that underlie the exemption of open-end shares also support the exemption of shares of closed-end companies that make periodic repurchases at a price based on net asset value.

## 5. Leverage

The issuance of senior securities by a closed-end company that periodically repurchases its shares presents two concerns. First, unless new equity is raised, repurchases will shrink the company's asset base, effectively increasing leverage and the riskiness of senior securities. Second, section 18(a) of the Act requires that the terms of senior securities prohibit repurchases of common stock if the repurchases would reduce the asset coverage below the required level. This prohibition creates potential uncertainty regarding scheduled repurchases of common stock. It was intended to respond to closed-end company practices in the 1920's and 1930's, when companies sometimes issued senior securities to the public, then repurchased common shares, leaving the senior securities holders with speculative instruments. If a scheduled repurchase would reduce the company's asset coverage below that required, the repurchase cannot occur unless the company takes other steps, such as retiring senior securities or selling additional common stock. There might be investor confusion if closed-end companies were to schedule repurchases only subject to the proviso that repurchases would not occur if they would reduce asset coverage below that required by section 18.

Accordingly, a repurchase rule for closed-end companies must ensure both that repurchases do not impair necessary asset coverage and that companies' levels of senior securities do not inhibit the companies' ability to meet their repurchase commitments. Accordingly, the Division recommends that closed-end companies making periodic repurchases should be limited to bank borrowing<sup>120</sup>

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<sup>120</sup>Some of the closed-end companies that make periodic repurchase offers have bank lines of credit to provide financing for their tender offers. Even if these companies do not use these sources of financing, the commitment fees can add to shareholder expenses. In rulemaking it may be appropriate to consider whether any limitation beyond the provisions of section 18 should be imposed on the use of borrowing to fund the repurchase of shares or on the allocation of borrowing expenses between shares that are tendered for repurchase and those that remain.

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under the same standards that apply to open-end funds.<sup>121</sup> This requirement would ensure that a company could make the maximum permitted repurchase offer without running afoul of the requirements of section 18.

## B. Limited Redemption Investment Companies

The Division also recommends that the Commission adopt rules providing carefully circumscribed exemptions from the requirement in section 22(e) that open-end companies pay redemption proceeds within seven days. To satisfy this requirement, open-end companies generally must maintain a relatively high degree of portfolio liquidity in order to pay redemption proceeds within seven days.<sup>122</sup> Thus, investment companies purchasing less liquid securities, notably companies investing in foreign securities, generally register as closed-end companies despite the perceived disadvantages of the closed-end form. Pursuant to the Commission's exemptive authority under section 6(c) of the Act,<sup>123</sup> the recommended rule would enable companies issuing *redeemable* securities and investing in securities with limited liquidity to operate within the open-end form with more limited redemption requirements than those traditionally applicable to mutual funds. Hence, we would use the term "limited redemption investment company" to refer to open-end companies that would operate under the rules that we recommend.

We have identified two major forms that a limited redemption investment company could take. The first form, referred to as the "extended payment"

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<sup>121</sup>Such an approach would follow the provisions of the exemptive order in Wisconsin Investment Company, 10 S.E.C. 555 (1941), in which the Commission permitted a closed-end company, which continuously offered its shares, to make periodic repurchases without complying with the predecessor of rule 23c-1, provided the company complied with provisions of the Act that are applicable only to open-end companies.

<sup>122</sup>The Commission has stated that open-end investment companies may hold no more than 15% of their assets in illiquid assets. See Guide 4 to Form N-1A, *supra* note 34.

<sup>123</sup>15 U.S.C. § 80a-6(c). The Commission has previously granted exemptions from section 22(e) to permit issuers investing in less liquid securities to pay redemption proceeds on an intermittent basis or in longer than seven days. See, e.g., American Federation of Labor and Congress of Industrial Organizations Mortgage Investment Trust, Investment Company Act Release Nos. 10650 (Mar. 30, 1979) (Notice of Application), 44 FR 21094, and 10674 (Apr. 26, 1979) (Order) (redemptions only during period preceding quarterly valuation dates of commingled trust fund investing in loans to union built housing); Mutual Investment Fund of Connecticut, Inc., Investment Company Act Release Nos. 2457 (Dec. 12, 1956) (Notice of Application), and 2465 (Dec. 31, 1956) (Order) (investment fund for Connecticut savings banks might limit redemptions on any one day, and by-laws provided for seven business days to pay redemptions); Savings Bank Investment Fund, 24 S.E.C. 531 (1946) (Order) (mutual investment fund for Massachusetts savings banks invested in mortgages and other assets and might take ten days to pay redemption requests).

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company, would offer to redeem its shares every day subject to a rolling payout period of, for example, thirty days that would begin to run for each shareholder on the day the shareholder presents shares for payment. Otherwise, the extended payment company would operate like a traditional open-end company. Extended payment companies would accept shares for redemption daily, would be subject to daily pricing requirements, and most likely would offer and sell securities continuously, just like open-end companies.

The second form of limited redemption company, referred to as the "interval" company, would redeem shares periodically at set intervals, such as monthly or quarterly. In order for interval companies to be able to manage their portfolios and have cash available to meet redemptions, the Division recommends that they be permitted to require shareholders to give a reasonable amount of advance notice before redeeming. Interval companies have the potential to be more complex. Because they would redeem only periodically, some interval companies may wish to adopt procedures for selling new shares other than daily.

Beyond those general points, the Division has not set forth in detail all of the requirements of a rule permitting limited redemptions. There are no operating models upon which to base assumptions as to what kinds of portfolios sponsors would wish to offer and what kinds of modified redemption features investors would want or accept. Accordingly, many of the specifics must be worked out through the rulemaking process. The following discussion addresses several of the chief considerations regarding the operation of both types of limited redemption companies to be addressed during the rulemaking process.

## **1. Pricing of Shares for Redemption**

For both extended payment and interval companies, the time between the date of tender and the date of payment would extend beyond the seven day maximum for traditional mutual funds. This extended period raises several concerns in determining the appropriate time to calculate redemption prices for these companies. Even with mutual funds, the value of a fund's assets can fluctuate between the time a shareholder places a redemption order and the time net asset value is determined, as well as over the seven days between the day the order is given and the date by which the fund must make payment. Thus, shareholders may be priced out of the fund based on asset values that decline significantly before redemption proceeds are actually paid or before portfolio securities are actually sold. Excluding periods of market volatility, however, the amount of fluctuation generally is small so that market changes cause minimal change in either the net asset value paid for redeeming shares, or the net asset value of remaining shares. With a longer period of, for example, fourteen or thirty days, the range of possible fluctuation is much greater.

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Like closed-end company repurchase offers, limited redemptions raise several concerns in deciding whether pricing should be calculated closer to the date of tender or to the date of payment. The most equitable method of pricing may depend, in part, upon the liquidity and composition of the portfolio. For example, thirty day "rolling" redemptions (of the extended payment type) would be most feasible in cases where the company's portfolio contains securities that are traded in formal marketplaces, such as overseas exchanges. While such a company would need a longer payout period to accommodate overseas settlement and currency exchange procedures, the company would be reasonably assured of obtaining accurate prices daily. Thus, an extended payment company might be able to price redemptions near the time of tender.<sup>124</sup>

Redemptions at periodic intervals, however, may be preferred where the company's portfolio securities are thinly traded and valuations based on actual market transactions are not available. Limiting redemptions to set periods, with advance notice of redemptions from shareholders, may be needed for the manager to plan for redemptions and, at the same time, manage the portfolio with the least disruption. Because portfolio transactions would be more concentrated around specific redemption periods, and because pricing would be less reliable, it may be more equitable for the company to price redemptions close to the payment of proceeds.<sup>125</sup>

Thus, different portfolios may be able to price redemptions fairly and accurately according to different procedures. In the rulemaking process, the proposing release should seek information regarding the portfolio management practices of companies that invest in less liquid securities. The Division also recommends that the Commission request comment regarding the level of liquidity necessary to deal effectively with limited redemption procedures. Finally, the Commission should request comment regarding the most equitable way to price redemptions.

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<sup>124</sup>To the extent, however, that a company with substantial foreign investments relied upon receipt of proceeds from selling securities abroad, the precise amount of those proceeds may vary with currency exchange rate fluctuations. In such circumstances, pricing near the time of tender might not provide the most equitable treatment.

<sup>125</sup>*Cf.* Memorandum accompanying Letter from the Investment Company Institute to Jonathan G. Katz, Secretary, SEC 3-4 (Aug. 8,1991, File No. S7-11-90 [hereinafter ICI Aug. 8,1991 Study Comment]) (discussing different options for periodic redemption procedures). The ICI argued that the timing of pricing should be left to the business judgment of fund management. At least initially, we question whether this deference would provide adequate investor protection.

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## **2. Interval Company Notice of Redemption**

As noted above, an interval company would redeem shares periodically on set dates, such as monthly or quarterly. While the length of the interval would be determined by the company, the Division believes that it should be an easily recognizable period and, at least at the outset, one of a limited choice of intervals (*e.g.*, biweekly, monthly, or quarterly, not every twenty-three days). The Division recommends that interval companies be permitted to require redeeming shareholders to provide notice in advance of the specified redemption date. Advance notice would enable managers to adjust their portfolios to accommodate redemptions.

We expect that the period between shareholder notice and redemption payment might vary depending on the length of the interval. Companies with different portfolio composition may require different notice periods. For example, the less liquid the company's portfolio, the more notice the manager likely would need. We anticipate that at most thirty days' notice would be sufficient for most interval companies. Longer periods in all likelihood would be undesirable from the investor's standpoint. The longer payout period allowed for interval companies would be in lieu of, and not tacked onto, the seven-day period required by section 22(e).

This requirement would depart significantly from the current practice of open-end companies. Because shareholders would have to be aware of the company's redemption dates and notice procedures, the rule should require the company to establish and disclose the notice period and the terms and conditions surrounding notice as matters of fundamental policy.<sup>126</sup>

## **3. Pricing Procedures for Issuing Shares**

The Division anticipates that limited redemption companies generally would offer new shares continuously, much like traditional open-end companies, and recommends that such companies should be required to price their shares daily under rule 22c-1 to the extent feasible.<sup>127</sup> The task of pricing less liquid portfolio securities, however, may be so time-consuming and expensive that daily pricing may not be feasible for some companies wishing to use the interval form. Industry representatives have advised us that some companies may prefer to

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<sup>126</sup>See *supra* note 92 (regarding treatment of closed-end procedures as matters of fundamental policy).

<sup>127</sup>The Act itself does not require daily pricing. The Commission instituted the daily pricing requirement pursuant to its authority in section 22(c) to make rules concerning the pricing of redeemable securities. Closed-end companies are required only to compute prices quarterly for reporting purposes, although many voluntarily price weekly for publication in the trade press.

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forego offering new shares continuously to avoid the burden of daily pricing.<sup>128</sup> Thus, some limited redemption companies, especially interval companies, may prefer to determine the prices of shares, and issue new shares, less frequently than daily. Accordingly, the Commission may need to modify rule 22c-1 or adopt new procedures specifically governing the pricing of sales of shares of limited redemption companies.

Some interval companies might wish to limit their sales to specific days or periods.<sup>129</sup> For example, some companies might wish to offer continuously, but to issue new shares at set "closings" that are scheduled weekly, monthly, or according to some recognizable interval. This option would be similar to a practice engaged in by certain closed-end companies.<sup>130</sup> Other companies might prefer to offer and sell new shares only during certain periods. This option would allow interval companies to coordinate redemption and offering periods, and thus to offset shrinking assets with cash from sales of new shares. For example, an interval company might offer new shares only during the period from the deadline for redemption requests until the date redemption proceeds are paid. Still other companies might prefer to arrange their offering periods to coincide with times when the companies expect that attractive investment opportunities might be available.

Such limitations raise significant questions about the extent to which Commission rules governing limited redemption pricing should prescribe clear limitations or grant issuers operational flexibility. The first question is the minimum frequency of pricing. To ensure fairness to shareholders and to provide

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<sup>128</sup>See ICI Aug. 8, 1991 Study Comment, *supra* note 125. Rule 22c-1(b) requires issuers of redeemable securities to calculate net asset value daily (excluding weekends and holidays) except on (i) days on which changes in the value of the investment company's portfolio securities will not materially affect the current net asset value of the investment company's redeemable securities; or (ii) days during which no security is tendered for redemption and no order to purchase or sell such security is received by the investment company. Interval companies may be able to use the second exception.

<sup>129</sup>Nothing in the Investment Company Act would require an interval company, as an issuer of redeemable securities, to engage in continuous offerings. Open-end companies have stopped offering new shares in certain circumstances, such as when their assets are so large that it is difficult to maintain investment returns or find investments that are consistent with investment objectives.

<sup>130</sup>Certain registered closed-end limited partnerships have combined continuous offerings and multiple closings to offer participations in portfolios composed of securities issued in conjunction with the so-called "mezzanine financing" of leveraged acquisitions and similar transactions. These offerings were registered on Form N-2, in compliance with rule 415 under the Securities Act. Because interval companies would be regulated as open-end companies, and since rule 415 does not apply to open-end funds, compliance with rule 415 would not be necessary.

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reliable information in connection with any secondary market that may develop,<sup>131</sup> however, the Division recommends that companies be required to calculate the price **of** their shares according to some minimum schedule -- if not daily, then perhaps at least weekly -- whether or not they are currently selling new shares. The reasonableness of such requirements would be explored during the rulemaking process. In addition, interval companies whose shares are traded in secondary markets may be required to recalculate the price of their shares if there is reason to believe that net asset value has changed materially.

Another question is when new shares would be priced vis-à-vis redemptions. With open-end companies, both redemptions and sales are priced daily and, thus, incoming and outgoing shareholders receive the same price. In a "multiple closing" situation, however, a company may wish, for example, to price sales every Friday and redemptions on the last day of each quarter (a redemption date) whether or not it falls on a Friday. In the case of a company selling new shares only during redemption payout periods, depending on when the company prices redemptions, investors coming into the com any may or may not receive the same price as investors exiting the company<sup>32</sup> In the latter case, at least, it may be fair to require that the same price apply to both incoming and outgoing investors, and hence that purchases of shares and redemptions take place only on the designated redemption date. In addition, the Division believes that, to avoid serious investor confusion, selling and redemption periods should be arranged according to easily recognizable schedules.

Finally, another question is whether the Commission should require companies to establish an appropriate mechanism for handling orders for new shares between sale dates. Escrow accounts or temporary investment in affiliated money market funds may provide such a mechanism. The rulemaking process should provide a clearer picture of how these mechanisms might work and **of** whether such mechanisms would increase administrative costs, and hence shareholder expenses. In addition, escrow accounts or temporary investments may also raise questions about investor's legal relationship with the company and rights in the company's securities.

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<sup>131</sup>In Chapter 8, we recommend the repeal of the retail price maintenance provision of section 22(d) of the Act, 15 U.S.C. § 80a-22(d); that repeal would permit the development of secondary markets in open-end company shares. Pending legislative action, however, the Division recommends that the rule proposal for limited redemption companies address whether to exempt some or all limited redemption companies from section 22(d).

<sup>132</sup>The Investment Company Institute suggested that companies that do not price on a daily basis should effect purchases only upon the designated redemption dates in order to give the same price for both purchases and redemptions; the ICI stated its impression that this is the practice of many illiquid private funds and bank collective funds. ICI Aug. 8, 1991 Study Comment, *supra* note 125, at 4.

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#### 4. Regulation As Open-End Companies

Both extended payment and interval companies would be regulated as open-end companies. As such, these companies would be subject to the open-end leverage restrictions of section 18. They would be permitted to impose asset-based distribution fees as provided under rule 12b-1 under the Act.<sup>133</sup> In addition, we anticipate that all limited redemption companies would register their shares on Form N1-A and, in doing so, would be able to use the provisions of sections 24(e) and 24(f) of the Act and the rules thereunder.<sup>134</sup>

To prevent investor confusion between such limited redemption companies and traditional open-end companies, limited redemption companies should be prohibited from calling themselves "mutual funds."<sup>135</sup> To further ensure that investors would not mistake the new companies for traditional mutual funds, the redemption and offering features of each company should be prominently disclosed. Extended payment companies pose the greatest risk that investors would confuse them with traditional open-end companies; the major difference between them would be the time in which the company is required to pay redemption proceeds. It is critical that investors understand this difference before they invest. The Division believes, however, that investors are capable of understanding the consequences of investing in an extended payment company and that, with appropriate disclosure requirements, investors quickly would learn to consider the length of a company's redemption period in deciding whether to invest. Interval company prospectuses should disclose the redemption procedures prominently because they too would be a significant departure from the practices of open-end funds.

#### 5. Market Disruption

Interval companies could affect the markets adversely for certain portfolio securities by clustering portfolio transactions around specific redemption dates. For example, the market prices of portfolio securities could become artificially depressed in anticipation of heavy sales by the interval company, or the sales themselves could depress market prices, so that net asset value would be reduced,

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<sup>133</sup>17 C.F.R. § 270.12b-1.

<sup>134</sup>15 U.S.C. § 80a-24(e), (f).

<sup>135</sup>The term "mutual fund" historically has applied only to open-end management investment companies. See SEC, REPORT ON THE PUBLIC POLICY IMPLICATIONS OF INVESTMENT COMPANY GROWTH, H.R. Rep. No. 2337, 89th Cong., 2d. Sess. 43 n.69 (1966). We believe that the investing public generally is unfamiliar with the term "open-end company" but has come to use the term "mutual fund" to refer to open-end companies as those companies have operated traditionally. Our proposal would preserve that usage.

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and other investors in the same securities also would experience depressed asset values. Establishing appropriate liquidity standards may assist in preventing these market disruptions. In addition, it is possible to reduce the potential for clustering of portfolio transactions if the rule does not mandate that all companies redeeming at given intervals select the same payment dates; for example, if some companies that redeem monthly may do so on the first, while others may redeem on the fifteenth, transactions are more likely to be dispersed.

### C. Portfolio Liquidity

The Division's recommendations raise a number of questions about the appropriate degrees of liquidity for different categories of investment companies. The importance of portfolio liquidity cannot be overstated for any investment company that redeems or periodically repurchases its shares. Recent experiences with open-end real estate unit trusts in Australia reaffirm the tremendous risks inherent with open-end issuers that do not hold sufficient liquid assets; several of those trusts collapsed following massive shareholder redemptions that exhausted any buffer of liquid investments that the trusts had maintained.<sup>136</sup>

#### 1. Current Liquidity Requirements

Currently, the Commission's only liquidity standard is that an open-end company's aggregate holdings of illiquid assets must be limited to fifteen percent of the value of the fund's net assets.<sup>137</sup> The Commission has stated and reiterated that an "illiquid security" generally is any security that cannot be disposed of within seven days in the ordinary course of business at approximately

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<sup>136</sup>In the mid-1980's Australian open-end investment trusts investing in real estate related assets attracted significant investment. Following an economic slowdown in 1989, problems developed in the Australian real estate markets, including bankruptcies of developers, and declines in property values and rental income. The Estate Mortgage group of real estate trusts faced significant redemptions during this period; because the bulk of the trusts' investments were in real estate development and construction lending, the trusts did not have sufficient liquidity to meet the run of redemption demands. In April, 1990, regulators permitted the trusts to suspend redemptions. Subsequently, the Australian National Companies and Securities Commission (now the Australian Securities Commission) promulgated guidelines imposing liquidity standards on open-end trusts. Alan Cameron & Jennifer Puhach, *Unlisted Property Trusts Down Under*, INT'L FUND FORUM (Jan. 1991)(enclosure in letter from Allan S. Mostoff to Matthew A. Chambers, Assistant Director, Division of Investment Management, SEC (Feb. 20, 1991), File No. S7-11-90).

<sup>137</sup>See Guide 4 to Form N-1A, *supra* note 34.

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the amount at which the company has valued the instrument (the "seven day standard").<sup>138</sup>

No comparable liquidity standard has developed for closed-end companies. Because they do not issue redeemable shares, they have not needed the same capacity to raise cash promptly. Moreover, many closed-end companies serve as a vehicle for investing in less than fully liquid securities. At the same time, however, managers of other closed-end companies have kept their portfolios highly liquid in order to be able to take advantage of investment opportunities that may arise.

## 2. Proposed Statutory Liquidity Requirement

The purpose of the liquidity standard for open-end funds has been to ensure that such funds have capacity to meet redemptions pursuant to the requirement in section 22 that repurchase payment be made to shareholders within seven days following tender for redemption.<sup>139</sup> The Division believes that, as a general matter, any investment company that holds itself out as ready to redeem or repurchase its shares on a periodic basis should be required to have sufficient liquidity to meet those demands without causing material deviations from the valuation of its portfolio assets.<sup>140</sup> Accordingly, the Division recommends that express liquidity standards be established for all management investment companies that redeem or periodically repurchase their shares. Specifically, the Division recommends that the Commission seek legislation to amend section 12 of the Investment Company Act to impose an express liquidity requirement on open-end companies and on those closed-end companies that

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<sup>138</sup>Acquisition and Valuation of Certain Portfolio Instruments by Registered Investment Companies, Investment Company Act Release No. 14983, section II.A.4 (**Mar 12, 1986**), 51 FR 9773 (adopting amendments to rule 2a-7); Sec. Act Rel. 6862, *supra* note 34, at II.F, 55 FR at 17940. See also guides 12 and 13 of the guidelines to Form N-1A stating the view that "real estate for which there is no established market" and "debt securities for which there is not established market" should be included in the limit on illiquid assets; and Guidelines for the Preparation of Form N-8B-1, Investment Company Act Release No. 7221 (June 9, 1972), 37 FR 12790 (guidelines for the preparation of Form N-8B-1, a predecessor to Form N-1A), counting restricted securities, interests in real estate, and commodities futures contracts toward the limit on illiquid investments.

<sup>139</sup>Inv. Co. Act Rel. 5847, *supra* note 34.

<sup>140</sup>Thus, appropriate liquidity standards should address the same concerns as the portfolio liquidity requirements in the rule 1ob-6 exemption for Merrill Lynch High Income Municipal Bond Fund, Inc., *supra* notes 110 and 116.

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periodically repurchase their shares.<sup>141</sup> The appendix to this chapter contains the Division's proposed new paragraph to be added to section 12 of the Act.

As the proposed new paragraph indicates, however, the Division believes that the Act should not set specific requirements for each category of investment company. Specific requirements would run the risk of quickly becoming obsolete because of market changes. Rather, the Division believes that the statute should contain a general, self-effecting requirement that investment company portfolios have sufficient liquidity to meet any redemption or repurchase obligations. In addition, it should give the Commission authority to set specific liquidity requirements for different types of investment companies, including traditional open-end funds, limited redemption companies, and closed-end companies making periodic repurchases. While the final details of those requirements would emerge in the rulemaking process, the Division anticipates that the following issues would need to be addressed.

#### a. Definition of Liquidity

The current definition of portfolio liquidity applicable to open-end investment companies is a simple standard: a security either is liquid or is not, depending on whether it can be sold within seven days. The proposals outlined above, however, envision other categories of investment companies that would respond to shareholder tenders of shares on a less prompt and continuous basis than do mutual funds. Those other investment companies might need to satisfy different standards depending upon the degree of redeemability or repurchasability. For example, a different degree of liquidity may be necessary for a company that redeems in seven days than for a company that redeems in thirty days.<sup>142</sup>

Rulemaking also might consider what weight to give to factors that traditionally have been viewed as indicating illiquidity. For example, restricted securities have generally been viewed as illiquid regardless of convertibility or

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<sup>141</sup>Such requirements arguably could be promulgated by rule through amendments to rule 22c-1, through any rulemaking defining the circumstances in which closed-end companies may make periodic repurchases, and through any rulemaking permitting limited redemptions. Nevertheless, we recommend that the Commission propose a statutory liquidity requirement in order to make clear the fundamental importance of the appropriate degree of liquidity in investment company portfolios. Pending the adoption of a statutory provision, however, it might be appropriate to include liquidity provisions in the recommended rules for limited redemptions and periodic closed-end repurchases.

<sup>142</sup>This would be analogous to the approach recently taken by the Australian National Companies and Securities Commission, which promulgated special guidelines for unit trusts in August, 1990; under those guidelines, the required level of liquidity decreased as the redemption period increased. See Cameron & Puhach, *supra* note 136.

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fungibility with other securities. Such securities in fact may have varying degrees of liquidity, although they are not as liquid as, for example, New York Stock Exchange listed stocks. Conversely, even within the current category of liquid securities, some securities are more liquid than others. For example, securities of issuers with very large market capitalizations and securities that are designated components of an index such as the S&P 500 can be traded in very large blocks with minimal price effect; cash and cash equivalents have the highest liquidity of any assets.

### **b. Valuation**

Another issue to be explored is whether the definitions of liquidity should also incorporate some degree of reliability of valuation. The current seven day standard implicitly requires reliable valuation since it requires that a security be sellable within seven days at approximately the amount at which a company has valued the security. It is not clear whether some liquidity standards should permit an intermediate degree of reliability, as would occur if a security's valuation were susceptible upon disposition to some deviation from the value currently assigned by the company to the security. It might be difficult to construct a definition of such permissible deviation since it could be expected to fluctuate depending on market conditions.<sup>143</sup>

## **D. Definition of Redeemable Security**

The proposed new redemption and repurchase procedures raise interpretive questions concerning the definition of "redeemable security" in section 2(a)(32) of the Act. The definition is key to the distinction between open-end and closed-end companies because, under section 5, any management company that issues redeemable securities is an open-end company; conversely, a closed-end company may not issue redeemable securities. The first question is whether limited redemption rights, and in particular periodic redemptions, would be inconsistent with that definition. The second question is whether closed-end companies would issue redeemable securities if they offer to repurchase shares from investors at net asset value according to a set schedule; if so, then the company could not be a closed-end company. Although the recommended repurchase and redemption procedures depart from practices that traditionally have characterized the two categories of management companies, the Division believes that, under the procedures outlined above, the shares of limited

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<sup>143</sup>Indeed, in some cases, the extent to which investment companies participate in certain markets can have a significant impact on the liquidity and pricing of the markets. This appears to have been the case in the last few years in the market for junk bonds, where recent new issuances and price increases have been attributed by some analysts to extensive purchases by mutual funds. See also George Anders, *Junk Bond Issuance Soar to Hottest Pace Since '88*, WALL ST. J., Dec. 2, 1991, at C1.

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redemption companies would be redeemable securities, while the shares of closed-end companies making periodic repurchase offers would not.

## 1. Limited Redemption Rights

Section 2(a)(32) defines a redeemable security as

any security, other than short-term paper, under the terms of which the holder, upon its presentation to the issuer or to a person designated by the issuer, is entitled (whether absolutely or only out of surplus) to receive approximately his proportionate share of the issuer's current net assets, or the cash equivalent thereof.

Interpretive questions about what is a redeemable security have arisen primarily in the context of section 3(c)(5) of the Act,<sup>144</sup> which excepts certain companies from the definition of investment company provided, in part, that they do *not* issue redeemable securities. The chief characteristic that distinguishes a redeemable security is whether the security is redeemable at the option of the holder, rather than of the issuer. This is the direct implication of the statutory wording: the holder of a redeemable security is *entitled* to receive redemption proceeds *upon presentation* to the issuer. This distinction is also clear from the legislative history of section 3(c)(5), which was amended in 1970 to include the prohibition on issuing redeemable securities:

Thus, the proposed amendment would in no way affect companies which issue securities redeemable at the option of the issuer -- the conventional form of redeemable security commonly used in corporate financing. The amendment applies only to those companies which purport to model themselves after open end companies by issuing a security redeemable at the option of the holder.<sup>145</sup>

No-action letters have been issued to companies that voluntarily make a practice of redeeming securities, but do not give the holder an unqualified right to compel the company to redeem, on the basis that the companies had not issued

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<sup>144</sup>15 U.S.C. § 80a-3(c)(5). Issuers relying on section 3(c)(5) also cannot issue face-amount certificates or periodic payment plan certificates and must be primarily engaged in certain specified types of businesses.

<sup>145</sup>INVESTMENT COMPANY AMENDMENTS ACT OF 1969, S. REP. NO. 184, 91st Cong., 1st Sess. 37 (1969); INVESTMENT COMPANY AMENDMENT ACT OF 1970, H.R. REP. NO. 1382, 91st Cong., 2d Sess. 17 (1970).

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redeemable securities and, thus, were eligible for the section 3(c)(5) exception.<sup>146</sup> No-action relief has been declined for a section 3(c)(5) company that proposed to give investors the right to have their shares redeemed ninety days after presentment on the theory that a security which is redeemable in accordance with its terms is a redeemable security even though it is only redeemable four times per year.<sup>147</sup>

The only question that arguably may remain is whether the definition requires a redeemable security to be redeemable at any time, *i.e.*, essentially upon demand. Such an interpretation would be inconsistent with redemptions at intervals. The language of section 2(a)(32) does not expressly require constant redeemability, but it might be possible to infer such a requirement if the phrase "upon its presentation to the issuer" were interpreted to mean "at any time that a holder tenders securities to the issuer." This reading arguably finds support in the testimony of former Commissioner Healy in describing to Congress in 1940 the differences between open-end and closed-end companies.<sup>148</sup> Section 2(a)(32), however, does not expressly require redemption requests to be honored *at any time*. Instead, any obligation to redeem on demand appears to arise under section 22(e) (concerning payment of redemption proceeds within seven days),<sup>149</sup> not under section 2(a)(32). To the extent that redemption at intervals

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<sup>146</sup>See, e.g., United Bankers, Inc. (pub. avail. Mar. 23, 1988); MBCH, Inc. (pub. avail. Dec. 16, 1981); Salomon Brothers, Inc. (pub. avail. June 17, 1985); Arthur D. Little, Inc. (pub. avail. Dec. 16, 1971).

<sup>147</sup>Hunton, Paige & Co., Inc. (pub. avail. Nov. 28, 1974). In addition, no-action letters under section 3(c)(5) have considered a number of other restrictions relating to the redeemability of securities; the specific details of the no-action requests have varied considerably.

<sup>148</sup>Healy remarked

The peculiarity of open-end companies is that they issue so-called redeemable securities -- that is, [a] security which provides that the holder may tender it to the company *at any time* and receive a sum of money roughly proportionate to the current market value of his share of the company assets.

1940 Senate Hearings, *supra* note 27, at 43 (emphasis supplied). Commissioner Healy's use of the phrase *at any time* arguably could imply that the holder of a redeemable security is entitled to receive redemption proceeds whenever the holder wishes, and that the company is not able to limit in any way that right. Nevertheless, Commissioner Healy's statements during the Senate hearings describing prior practices clearly do not constitute a definitive gloss on the subsequently enacted definition; for example, his description contemplates redemption only in cash, whereas section 2(a)(32) permits redemption either in cash or in kind, through the distribution of portfolio securities.

<sup>149</sup>Section 22(e) provides that "[n]o registered investment company shall suspend the right of redemption, or postpone the date of payment or satisfaction upon redemption of any redeemable (continued..)

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might be considered a departure from the redemption rights that shareholders traditionally have had in open-end companies to redeem shares promptly on demand,<sup>150</sup> the Commission could always use its authority to promulgate rules clarifying the status under section 2(a)(32) of limited redemption companies, as well as the status of closed-end companies making periodic repurchase offers.

The Division recognizes that it would be untenable to suggest that a security which is redeemable at the option of the holder in accordance with its terms is a redeemable security no matter what those terms are; such a position would give open-end companies *carte blanche* to impose all kinds of restrictions on redemption rights. For example, at some point, the interval between redemptions could become so long that the company should not be regarded as an issuer of redeemable securities. We have concluded, however, that redemption rights that are limited solely with respect to the times during which presentation will be accepted by the company, or the length of the delay before proceeds are received, do not offend the statutory scheme as long as the parameters of such rights are tightly controlled by rule to prevent possible harm to investors and to assure some degree of *real* redeemability. For this reason, the rule should require that an interval company redeem shares at one of several intervals specified by the rule, but no less frequently than quarterly. Companies wishing to provide liquidity to shareholders at longer intervals should not be able to operate as limited redemption companies but might be organized as closed-end companies using the repurchase rule.

## **2. Periodic Repurchases of Closed-End Shares**

Conversely, the Division believes that repurchases of securities by closed-end companies under the circumstances proposed would not render the securities redeemable within the meaning of section 2(a)(32). There is a critical difference between companies offering limited redemptions and companies committing to repurchase their shares. The former company's securities are redeemable because the redemptions are at the option of the security holder. The latter does not issue redeemable securities because the holder is not entitled upon presentation to the company to receive approximately his or her proportionate share of the company's net assets as required by section 2(a)(32). Rather, significant restrictions on the repurchases would apply, and control over most aspects of the

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<sup>149</sup>(...continued)  
security in accordance with its terms for more than seven days" except under specified circumstances.

<sup>150</sup>See *United States v. National Ass'n of Sec. Dealers*, 422 U.S. 694, 698 (1975) (under sections 2(a)(32) and 22(e), open-end companies are required to redeem securities on demand); *United States v. Cartwright*, 411 U.S. 546, 547 (1973) (section 22(e) requires open-end companies to be prepared to redeem their outstanding shares at any time).

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repurchase process would remain with the company.<sup>151</sup> While the repurchases would be conducted at net asset value pursuant to modified tender offer procedures, and the company would be subject to liquidity standards, there also is a real possibility that the company may not purchase all of the shares tendered at any particular time. In particular, the rule would require a company to establish a fundamental policy specifying the maximum amount that the company could repurchase in any repurchase offer; and at the time of each offer, the company could establish a lower maximum for that offer. If more shares were tendered than the company had offered to repurchase, the company would have only limited capacity to increase the offer. Moreover, the rule should restrict the permissible levels of repurchase offers so that a company could not guarantee to repurchase all shares tendered; for example, a company could not set a policy of offering to repurchase all of its outstanding shares. As a result, the primary characteristic of a redeemable security -- the entitlement it provides the holder -- would not be present. This conclusion is consistent with previous interpretations of the Act stating that a closed-end company does not issue a redeemable security if the company decides whether or not to accept the shares tendered.<sup>152</sup> This conclusion is also consistent with the no-action positions holding that companies do not issue redeemable securities if they do not give holders an unqualified right to compel redemption.<sup>153</sup>

#### **IV. Conclusion**

The Division recommends that the Commission adopt an exemptive rule under section 23 of the Investment Company Act defining the circumstances under which closed-end companies may make periodic repurchase offers, and a rule under section 22(e) permitting open-end companies to make redemptions on a periodic basis or with an extended period of payment. In conjunction with those proposals, the Division also recommends the amendment of the Act to add an express requirement of portfolio liquidity for all open-end companies and all closed-end companies making periodic repurchases.

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<sup>151</sup>*Cf. Dimensional Fund Advisors, Inc., supra note 73* (rejecting the argument that nominal limitations on redeemability made securities non-redeemable).

<sup>152</sup>*See id.* Conversely, securities are redeemable if the issuer or its board has limited ability to defer redemption payments under unusual circumstances, such as the exceptions specified in section 22(e). See also *Savings Bank Investment Fund*, 24 S.E.C. at 539-40 (securities were redeemable securities under the Act even though executive committee was authorized to defer payment of redemptions under extraordinary circumstances).

<sup>153</sup>*See supra note 146.*

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## APPENDIX 11-A

### **Red-Lined Version of Proposed Amendment to the Investment Company Act of 1940**

(new language is shaded)

#### Section 12[15 U.S.C. § 80a-12].

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(C) It shall be unlawful for any registered management investment company to purchase or otherwise acquire any illiquid asset if, as a result of such purchase or acquisition, the assets of such company would be sufficiently illiquid as to impair the company's capacity (A) to make payment to shareholders upon tender within the period of time within which the company is required to make payment upon tender for redemption pursuant to section 22 of this title, or upon tender for repurchase pursuant to section 23 of this title, or (B) to determine accurately the value of its assets. For purposes of this paragraph, "illiquid asset" includes (A) any asset that an investment company reasonably cannot expect to sell (i) at approximately the amount at which the company would value the asset, and (ii) in the ordinary course of business within the period of time within which the company is required to make payment upon redemption pursuant to section 22 of this title, or upon repurchase pursuant to section 23 of this title; and (B) such other asset or class or classes of assets as the Commission may, by rule or regulation or order, define as illiquid. The Commission may, for the purposes of this paragraph, by rules and regulations define and prescribe requirements reasonably designed to ensure that a registered company's assets are liquid to the extent necessary or appropriate in the public interest or for the protection of investors.

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## Chapter 12

# Affiliated Transactions

### I. Introduction and Summary of Recommendations

Several provisions of the Investment Company Act<sup>1</sup> restrict transactions involving investment companies and their affiliates. Most notably, section 17<sup>2</sup> prohibits or restricts a wide range of affiliated transactions, and section 10(f)<sup>3</sup> limits an investment company's acquisition of securities from an underwriting syndicate containing certain affiliates. The restrictions on affiliated transactions were enacted in 1940 in response to a wide array of abuses that occurred in the 1920's and 1930's. The Division has concluded that these restrictions remain sound and should be preserved in all critical respects. For more than fifty years they have played a vital role in protecting the interests of shareholders and in preserving the industry's reputation for integrity; they continue to be among the most important of the Act's many protections.

The breadth of some of these provisions, however, prohibits some transactions that do not involve the concerns the provisions are intended to address, and the process of applying for exemptive relief can impose delays and costs upon investment companies and may deter them from pursuing beneficial investments. Accordingly, the Division recommends rulemaking proceedings to narrow the prohibitions on affiliated transactions in certain limited areas where current prohibitions can be relaxed without reducing the protection of investment companies and their shareholders.

In particular, the restrictions in section 17(d) and rule 17d-1<sup>4</sup> on a particular form of affiliated transaction, the "joint" transaction, unduly inhibit some types of transactions that pose little risk of conflict of interest. The Division therefore recommends that the Commission broaden the classes of transactions currently permitted in two areas. First, the Division recommends allowing directors of investment companies to authorize joint transactions with remote affiliates, rather than requiring that such transactions be reviewed by the Commission. The Division does not, however, recommend allowing directors to

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<sup>1</sup>Investment Company Act of 1940, 15 U.S.C. § 80a.

<sup>2</sup>15 U.S.C. § 80a-17.

<sup>3</sup>15 U.S.C. § 80a-10(f).

<sup>4</sup>17 C.F.R. § 270.17d-1.

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approve other affiliated transactions such as principal transactions or transactions with closer affiliates, because such other transactions present greater risks of conflicts of interest. Second, the Division recommends exempting joint transactions where an investment company and its affiliates participate on the same terms, except to the extent of their participation.

In addition, the Division recommends that the Commission revise rule 10f-3 to permit investment companies to purchase securities in foreign markets in underwritings involving affiliates. That rule currently exempts certain transactions from the Act's prohibition on investment company purchases from an underwriting syndicate that includes an affiliate, but in practice the exemption does not reach transactions involving foreign offerings.

This chapter begins by describing the current regulatory framework governing affiliated transactions. It then discusses briefly how that framework has been altered for business development companies. Finally, it analyzes the various options for reform considered by the Division and sets forth the Division's recommendations.

## **11. Current Regulation of Affiliated Transactions Under the Investment Company Act**

The Investment Company Act's provisions concerning affiliated transactions were enacted in response to the Commission's exhaustive report on the investment company industry. The Investment Trust Study described in great detail numerous instances of overreaching and self-dealing by investment company insiders. The Commission found that:

[s]ponsors, in their capacity as sellers of securities to and purchasers of securities from investment companies, perpetrated many abuses. They not only sold securities to investment companies to realize profits as principal[s] or commissions as brokers, but also sold securities to these companies for a variety of other reasons. For example, "dumping" (selling to a controlled investment company securities which are otherwise unmarketable at the sale price) was very common. Also, the sponsors frequently sold securities to their investment companies in order to secure, facilitate, or maintain control of the portfolio companies, or to aid in

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mergers, consolidations, or other objectives of [the] sponsors. Sales were also made to investment companies by sponsors to secure various indirect benefits?

The resulting regulatory framework included restrictions on transactions involving investment companies and their affiliates. These are summarized below.

## A. Investment Companies

### 1. Affiliation under the Act

The Act's restrictions apply to transactions with persons having various degrees of affiliation with an investment company. For example, the affiliates subject to section 17(a) include any affiliated person<sup>6</sup> or promoter of or principal underwriter for a registered investment company (a "first tier" affiliate), or any affiliated person of such a person, promoter, or underwriter (a "second tier" affiliate)<sup>7</sup>. Other provisions of the Act apply to transactions with slightly different combinations of affiliates.

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<sup>5</sup>SEC, INVESTMENT TRUSTS AND INVESTMENT COMPANIES, PT. 3, H.R. Doc. No. 136, 77th Cong., 1st Sess., at 2581 (1939) [hereinafter INVESTMENT TRUST STUDY]. The Commission devoted over 200 pages of the Investment Trust Study to the discussion of specific instances of overreaching by affiliates in connection with the purchase and sale of portfolio securities, loans by investment companies, and investments in related investment companies. Id. at 2581-2793.

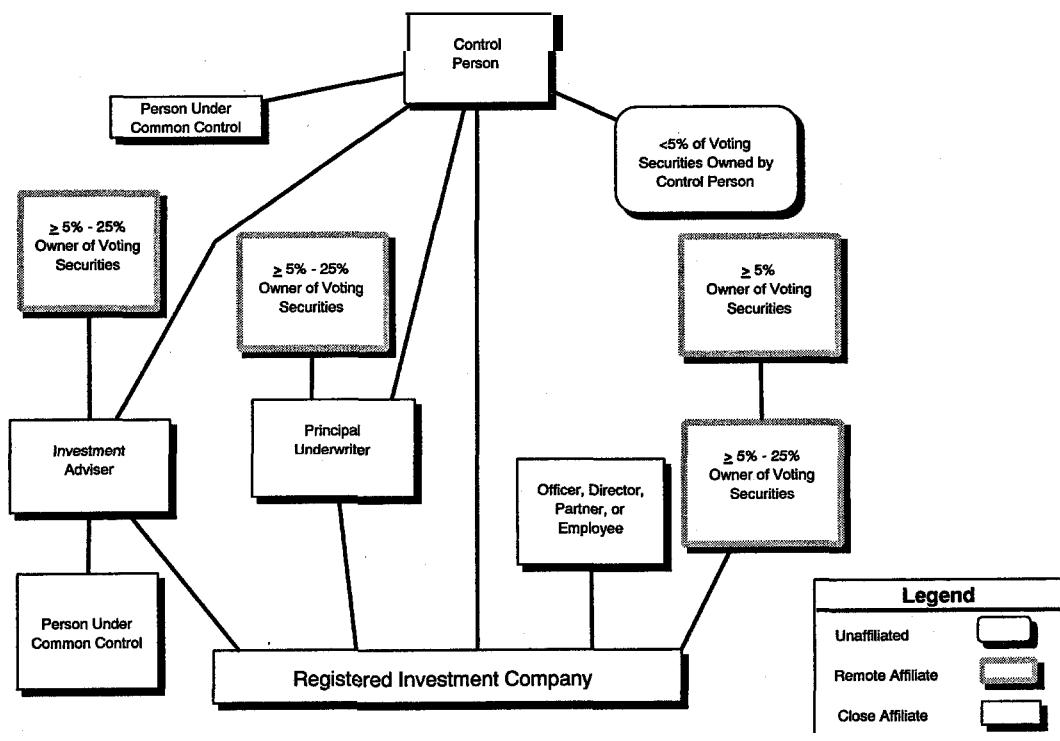
<sup>6</sup>Section 2(a)(3) defines an "affiliated person" of an investment company to include any person owning five percent or more of the investment company's voting securities; any person in which the investment company owns five percent or more of the voting securities; any person directly or indirectly controlling, controlled by, or under common control with, the investment company; any of the company's officers, directors, partners, or employees; the investment adviser and any members of an advisory board; and, in the case of a unit investment trust, the depositor. 15 U.S.C. § 80a-2(a)(3). For the sake of brevity, this chapter uses the term "affiliate" when referring to persons subject to sections 10(f), 17(a), and 17(d) of the Act and rule 17d-1 thereunder.

<sup>7</sup>These sets of affiliated relationships are referred to as "tiers" for convenience. In fact, each of these tiers often consists of intricate, multi-leveled sets of entities that are directly or indirectly under common control.

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Figure 12-1, below, depicts certain registered investment company upstream affiliated relationships.

**FIGURE 12-1**  
**Upstream Affiliations**



The depictions in Figure 12-1 include one entity that is “unaffiliated” with the investment company (see Legend); transactions between this entity and the investment company are outside of section 17’s scope. Six of the depicted entities, on the other hand, are close affiliates of the investment company; transactions between these entities and the investment company generally must be approved by the Commission. Four of the depicted entities are remote affiliates of the investment company. Under the terms of the Division’s proposed amendments to rule 17d-1, discussed below, the investment company could engage in certain joint transactions with these remote affiliates if approved by the company’s board of directors, rather than the Commission.

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## **2. Section 17(a)**

Section 17(a) makes it unlawful for any first or second tier affiliate of a registered investment company (1)knowingly to sell securities or property to the company; (2) knowingly to purchase securities or property from the company; or (3) to borrow money or property from the company. Thus, section 17(a) prohibits transactions with first or second tier affiliates and applies only where the affiliate is acting as principal<sup>8</sup> (Section 17(e), discussed below, applies to agency transactions.) Under section 17(b), the Commission, upon application, shall exempt a proposed transaction from section 17(a) if it finds that the proposed transaction is reasonable and fair and does not involve overreaching, is consistent with the policy of the company, and is consistent with the general purposes of the Act?

Under section 6(c),<sup>10</sup> the Commission has adopted eight rules exempting from section 17(a) certain classes of affiliated transactions that otherwise would require Commission exemptive orders. For example, rule 17a-7 permits funds that are affiliated persons solely by virtue of having common or related advisers, common directors, and/or common officers, to sell securities at market prices to each other, subject to certain conditions, one of which requires a form of director review. A fund's board, including a majority of the "independent" directors,<sup>11</sup> must adopt procedures that are reasonably designed to provide for compliance with the other conditions in the rule, annually review the procedures, and quarterly review all sales for compliance. Similarly, rule 17a-8 permits funds that are affiliated persons solely by virtue of having common or related advisers, common directors, and/or common officers to merge with one another if the funds' boards, including a majority of each board's independent directors, find

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<sup>8</sup>Section 17(c) exempts certain sales of merchandise and leases from the section 17(a) prohibition.

<sup>9</sup>If a registered company and a person covered by section 17(a) seek to engage in a series of transactions, the Commission may not exempt them under section 17(b). It may, however, use its authority in section 6(c) (15 U.S.C. § 80a-6(c)) to exempt the series of transactions with reference to the standards set forth in section 17(b). Keystone Custodian Funds, Inc., 21 S.E.C. 295, 299 (1945).

<sup>10</sup>15 U.S.C. § 80a-6(c).

<sup>11</sup>Section 10(a) generally provides that an investment company may not have a board more than 60% of the members of which are interested persons. "Interested person" is defined in section 2(a)(19) to include persons with certain relationships to the investment company or to the securities industry generally as well as persons with certain relationships with such persons. We use the term "independent directors" to refer to those directors who are not interested persons.

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that the transaction is in the best interests of the investment companies and that the interests of shareholders will not be diluted.<sup>12</sup>

### 3. Section 17(d) and Rule 17d-1

Section 17(d) makes it unlawful for an affiliated person of or principal underwriter for a registered investment company, or any affiliated person of such a person or principal Underwriter, acting as principal, to effect any transaction in which the registered company is a 'oint or a joint and several participant, in contravention of Commission rules."<sup>13</sup> In contrast to section 17(a), section 17(d) does not directly prohibit any specific conduct. Rather, it allows the Commission to adopt rules that set standards for transactions in which investment companies are joint participants.

The Commission has adopted three rules under section 17(d), the most significant of which is rule 17d-1.<sup>14</sup> Rule 17d-1 prohibits an affiliated person of or principal underwriter for any registered investment company, or any affiliated person of such person or underwriter, acting as principal, from participating in or effecting any transaction in connection with a joint enterprise or other joint arrangement in which the investment company is a participant, without prior

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<sup>12</sup>Rule 17a-1 exempts certain purchases by an investment company acting as an underwriter; rule 17a-2 exempts certain commercial transactions; rule 17a-3 exempts transactions with fully owned subsidiaries; rule 17a-4 exempts sales pursuant to certain contracts executed prior to the existence of any affiliation; rule 17a-5 exempts pro rata distributions to stockholders; and rule 17a-6 exempts certain transactions with "downstream" affiliates.

<sup>13</sup>The term "joint" has not been interpreted as requiring a strict common law meaning. Rather, only "some element of 'combination' is required." SEC v. Talley Indus., Inc., 399 F.2d 396,402-03 (2d Cir. 1968), *cert. denied*, 393 U.S. 1015(1969).

<sup>14</sup>For the first 17 years after the AcYs passage, the Commission prohibited very few joint transactions. The Commission first adopted a rule under section 17(d) in 1946. That rule concerned only bonus, profit-sharing, and pension plans and arrangements "provided by" investment companies "for directors, officers and other affiliated persons." Adoption of Rule Governing Applications Regarding Bonus, Profit-sharing and Pension Plans and Arrangements, Investment Company Act Release No. 858 (Feb. 6, 1946), 11 FR 1461. Thus, as originally promulgated, rule 17d-1 prohibited only a limited class of transactions with first tier affiliates. This version of the rule was later amended in Applications and Exemption of Transactions Between Registered Companies and Fully Owned Subsidiaries, Investment Company Act Release No. 1060 (June 23, 1947), 12 FR 3441, and Applications Regarding Bonus, Profit-sharing and Pension Plans, Investment Company Act Release No. 1598 (Mar. 20, 1951), 16 FR 2680. Rule 17d-1 in substantially its present form, prohibiting a broad range of joint transactions, was adopted in 1957. Applications Regarding Joint Enterprises and Certain Profit-sharing Plans, Investment Company Act Release No. 2472 (Jan. 10, 1957), 22 FR 426.

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Commission approval." Thus, the rule effectively prohibits joint transactions or arrangements involving either first tier or second tier affiliates, absent Commission approval.

The rule has limited exceptions for certain employee compensation plans, certain tax-deferred employee benefit plans, certain transactions involving small business investment companies, transactions with "downstream" affiliates (where the affiliation arises solely because of the investment company's portfolio holdings), the receipt of securities or cash by certain affiliates pursuant to a plan of reorganization, and arrangements regarding liability insurance policies.

The Commission has acknowledged that there is considerable uncertainty about the scope of the section and the rule.<sup>16</sup> In 1967, the Commission proposed amending the rule in an attempt to delineate its scope more precisely. In its release, the Commission observed that:

[u]nder the present Rule, it is in some circumstances unclear whether an application should or should not be filed, and a considerable amount of the staff's time is absorbed in assisting registered companies and their affiliates to determine the applicability of the filing requirement, apart from any determination of approval or disapproval on the merits.<sup>17</sup>

Among other things, the amendment would have reduced the number of affiliates subject to the rule by excluding five percent shareholders of five percent shareholders. It also would have excluded investment companies that are affiliated solely because they had the same adviser and would have attempted to

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<sup>15</sup>*Talley* held that the Commission did not exceed its authority when it adopted rule 17d-1, a procedural rule requiring prior approval, rather than a substantive rule. 399 F.2d at 404-05.

<sup>16</sup>In Steadman Security Corporation, Investment Company Act Release No. 9830 (June 29, 1977), 46 S.E.C. 896,911, the Commission stated that "[the generality of [the] language [of section 17(d),] together with the paucity of judicial decisions construing it, has led to considerable uncertainty as to its exact scope."

<sup>17</sup>Notice of Proposal to Adopt a Revision of Rule 17d-1 Requiring Applications For Transactions in Which Investment Companies Participate with Affiliated Persons, Investment Company Act Release No. 5128, [1966-67 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,477, at 82,949 (Oct. 13,1967).

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limit the class of transactions subject to the rule. The amendment was withdrawn, apparently in response to the criticism of commenters who believed the proposal would expand rather than clarify the rule.<sup>18</sup>

#### 4. Section 10(f) and Rule 10f-3

Section 10(f) generally prohibits a registered investment company from purchasing securities during the existence of an underwriting syndicate if a member of the syndicate is affiliated with the investment company in certain ways. Section 10(f) prevents an affiliated underwriter from "lacing" or "dumping" unmarketable securities with an investment company.<sup>19</sup> Section 10(f) also expressly provides the Commission with authority to exempt transactions by rule or by order.

Under its exemptive authority, the Commission has adopted rule 10f-3, which exempts purchases from an underwriting syndicate that includes an affiliate, subject to several conditions relating to the nature of the offering and the terms of an investment company's participation. In particular, the securities must either be registered under the Securities Act<sup>20</sup> or be municipal securities.

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<sup>18</sup>SEC Rule Proposals Withdrawn, Investment Company Act Release No. 5874, [1969-70 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,758 (Nov. 7, 1969). For example, the Investment Company Institute ("ICI") argued that the rule would have required applications for many coincidental purchases of securities where there was no joint participation. See Letter of Robert L. Augenblick, President, ICI, to the Commission (Jan. 17, 1968). Other attempts to reform the regulatory treatment of joint transactions have not been successful. According to the American Law Institute, for example:

the uncertainty as to the range of transactions covered by [section 17(d)], prompted an attempt at an entirely new approach to the section designed to clarify its coverage and relax its strictness to the extent of interposing the unrelated directors to blunt the intrusion of court or Commission in reviewing a challenged transaction. But disagreement among the Consultants and Advisers with respect to an acceptable (let alone a desirable) solution of the problems -- together with the rejection of proposed changes by spokesmen for the industry -- led to a decision, particularly in the light of the Code's limited approach to substantive revision of the Investment Company Act, to leave [section 17(d)] substantially as it is today.

2 ALLI. FED. SEC. CODE, § 1412 cmt. 3 (1980).

<sup>19</sup>One of the major abuses noted in the period preceding the Act was the use of investment companies as a "dumping ground" for otherwise unmarketable securities. See *Investment Trusts and Investment Companies: Hearings on S. 3580 Before a Subcomm. of the Senate Comm. on Banking and Currency*, 76th Cong., 3d Sess. 35 (1940) (statement of Commissioner Healy).

<sup>20</sup>Securities Act of 1933, 15 U.S.C. §§ 77a-77aa.

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## B. Business Development Companies

In 1980, Congress amended the Investment Company Act to allow for a less regulated type of management investment company, the business development company ("BDC").<sup>21</sup> Congress determined that the regulatory structure applicable to investment companies needed to be modified to facilitate venture capital formation.

The result is that although BDCs are subject to section 10(f) to the same extent as are registered investment companies, the treatment of other affiliated transactions involving BDCs is somewhat different. They are regulated under section 57<sup>22</sup> (rather than section 17) in one of two ways, depending on the closeness of the affiliation between the BDC and the affiliates involved in the transaction.<sup>23</sup> Transactions involving closer affiliates require prior Commission approval, as do transactions under section 17.<sup>24</sup> Transactions involving persons less closely affiliated with a BDC<sup>25</sup> may be approved by majority vote of the BDC's board, including a majority of the BDC's independent directors. The findings the directors must make are essentially the same as those required for Commission orders under section 17(b).

Thus, a BDC may engage in either principal or joint transactions with remote affiliates without seeking Commission approval if the directors of the BDC approve the transaction.<sup>26</sup> The 1980 amendments preserve the need for

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<sup>21</sup>Pub. L. No. 96-477, 94 Stat. 2275 (1980) (codified as amended at 15 U.S.C §§ 80a-53 to 80a-64).

<sup>22</sup>15 U.S.C. § 80a-56.

<sup>23</sup>Section 57 also differs from subsections (a) and (d) of section 17 in that it expressly prohibits only *knowingly* borrowing from, or engaging in joint transactions with, BDCs.

<sup>24</sup>Like section 17(d), section 57(a)(4) prohibits only those joint transactions with affiliated persons that are in contravention of Commission rules. Section 57(i), however, provides that, until the Commission adopts rules under subsection (a) and (d), the rules under subsections (a) and (d) of section 17 shall apply. Because the Commission has not adopted rules under section 57(d), rule 17d-1 requires prior Commission approval of those joint transactions involving BDCs that cannot be approved by BDC boards.

<sup>25</sup>These more remote affiliates are those specified in section 57(e). See infra note 45 and accompanying text.

<sup>26</sup>In addition, rule 57b-1 (17 C.F.R. § 270.57b-1) exempts transactions with certain "downstream affiliates" (affiliates that are directly or indirectly controlled by a BDC, and any persons controlling, controlled by, or under common control with, those controlled affiliates). Section 57 (continued..)

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Commission approval where an "upstream affiliate," such as an officer, director, investment adviser, principal underwriter, or controlling person of the BDC, is a participant. Thus, those transactions that present a greater risk of self-dealing remain subject to prior Commission review.<sup>27</sup>

Because the provisions of the Act concerning transactions involving BDCs and their affiliates are less restrictive than for other investment companies, the **Act** imposes additional governance requirements on BDCs to limit possible overreaching. Section 56(a)<sup>28</sup> requires that the majority of a BDC's board consist of persons who are not interested persons of the BDC, rather than the forty percent required of boards of registered investment companies under section 10(a). Section 57(h) requires that the directors adopt and periodically review and update procedures designed to monitor the possible involvement of those persons who are subject to the restrictions of section 57 in transactions with the BDC. Finally, section 57(f)(3) requires BDC directors to record in the minutes of their meetings detailed information about their decisions to approve transactions with affiliates.

### **III. Options for Reform and Recommendations**

As the Commission noted in the release seeking comments on the regulation of investment companies,<sup>29</sup> the prohibitions of section 17(a) and rule 17d-1 and the procedures for approval thereunder have been criticized as unduly

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<sup>26</sup>(...continued)

does not cover transactions with some affiliates that are covered by section 17(a). Specifically, section 57(f) does not limit transactions with persons a BDC controls or with which it is affiliated because it holds at least five percent of their outstanding securities, and affiliated persons of those persons. The Commission has adopted an exemptive rule, rule 17a-6, that provides essentially the same relief for investment companies.

<sup>27</sup>See SMALL BUSINESS SECURITIES ACTS AMENDMENTS OF 1980, S. REP. NO. 958, 96th Cong., 1st Sess. 7-8 (1980) [hereinafter 1980 SENATE REPORT].

<sup>28</sup>15 U.S.C. § 80a-55(a).

<sup>29</sup>Request for Comments on Reform of the Regulation of Investment Companies, Investment Company Act Release No. 17534 (June 15, 1990), 55 FR 25322, at § III.J.4. [hereinafter Study Release]. Unless otherwise indicated, all references in this chapter to commenters and comment letters are to those responding to the Study Release.

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cumbersome; and some commentators have criticized rule 17d-1 as overbroad, unclear, or inconsistent with the purpose of section 17(d).<sup>30</sup>

From the standpoint of cost and efficiency, it is desirable to limit the number of prohibited affiliated transactions requiring Commission approval and to clarify what transactions are prohibited. Moreover, because of the time and cost attendant to filing an application, it is probable that many transactions that do not involve overreaching are simply foregone; thus, the restrictions also may impose opportunity costs on investment companies.

From the standpoint of investor protection, however, the Investment Company Act's provisions concerning affiliated transactions are at its heart and continue to serve as a fundamental protection. The provisions were intended to go beyond those provided under common law, which allows fiduciaries to deal with their beneficiaries if adequate disclosure is made.<sup>31</sup> They are also greater than the protections provided to investors in other domestic pooled investment vehicles, such as common trust funds and real estate investment trusts, and in foreign investment companies.<sup>32</sup>

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<sup>30</sup>See, e.g., Joseph W. Bartlett & Stephen P. Dowd, *Section 17 of the Investment Company Act -- An Example of Regulation by Exemption*, 8 DEL. J. CORP. L. 449 (1983). In response to the Study Release, several commenters addressed affiliated transactions, including: certain members of a subcommittee of the American Bar Association; the American Council of Life Insurance; Citicorp; Debevoise & Plimpton, on behalf of the independent trustees of the Fidelity Funds; Dechert Price & Rhoads; The Equitable Life Assurance Society of the United States; Fidelity Management & Research Company; R. James Gormley; IDS Financial Services, Inc.; the ICI; Merrill Lynch & Co., Inc.; a committee of the Association of the Bar of the City of New York; Prudential Mutual Fund Management; Ropes & Gray; Shearson Lehman Brothers, Inc.; and Warburg Investment Management International, Ltd.

<sup>31</sup>See Thomas P. Lemke, *The Investment Company Act of 1940*, in **4** SECURITIES LAW TECHNIQUES TRANSACTIONS LITIGATION (A.A. Sommer, ed.) § 83-07, at 83-135 (Aug. 1991).

<sup>32</sup>For example, under the regulations of the Comptroller of the Currency, a common trust fund may engage in principal transactions with affiliates if authorized by the governing trust instrument, a court order, or the law of the jurisdiction under which the trust is administered. **12 C.F.R. § 9.12.** Some affiliated transactions may be approved by a majority of the bank's outside directors or "cured" through disclosure. *Id.* A real estate investment trust, under the statement of policy of the North American Securities Administrators Association, which (as of March, 1991) had been adopted in 20 states, may engage in certain transactions with affiliates if a majority of its trustees (or directors), including a majority of its independent trustees (or directors), approve the transaction. NASAA Reports (CCH) ¶¶ 263, 3404 (1991). The European Community's Directive on Undertakings For Collective Investment in Transferable Securities, discussed in Chapter 4, has no prohibition on transactions with affiliates. European Council Directive of 20th December 1985 on the Coordination of Laws, Regulations and Administrative Provisions Relating to Undertakings for Collective Investment in Transferable Securities, Council Directive 85/611, (continued..)

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The need for the protections provided by the affiliated transaction provisions of the Investment Company Act has not diminished with the passage of time and is amply demonstrated by a recent enforcement action, SEC v. *Groshans*.<sup>33</sup> In that case, the Commission obtained a permanent injunction against the chairman and president of a mutual fund, and the appointment of a trustee, based primarily on an affiliated transaction. The chairman sold all of the stock of a company in which he owned a ninety-six percent interest to the fund for shares of the fund. He then assigned an artificial value of \$1.05 per share to the stock and artificially raised the price of the stock each day thereafter causing the net asset value of the fund to be overstated. He eventually redeemed his fund shares for over \$2 million.<sup>34</sup>

Other sectors of the financial services industry demonstrate the consequences of similar kinds of transactions. Some of the most publicized abusive transactions in recent years have occurred in the savings and loan industry. In addition, some sources have estimated that various forms of "insider abuse" have played a significant role in bank failures.<sup>35</sup>

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<sup>32</sup>(...continued)

**1985 O.J. (L 375) 3.** The current trend in the United States, however, may be in favor of tighter controls, particularly with respect to principal transactions. For example, the Commodity Futures Trading Commission has proposed a rule that would prohibit a commodities pool operator ("CPO") from using funds or property of a commodities pool that it operates to lend money or property to or purchase assets of or securities issued by such CPO or any affiliated person of such CPO; "affiliated person of a CPO is defined as any entity in which the CPO has an "interest." Proposed Regulation Prohibiting Certain Transactions Between Commodity Pool Operators and Affiliated Persons, **56 FR 50067** (Oct. 3, 1991), corrected at **56 FR 55527** (Oct. 28, 1991).

<sup>33</sup>Civ. Act. No. **90-6703** (E.D. Pa.) [cited in Litigation Release No. 12677 (Oct. 19, 1990)].

<sup>34</sup>*Id.*

<sup>35</sup>See Note, *Insider Abuse and Criminal Misconduct in Financial Institutions: A Crisis?*, **64** NOTRE DAME L. REV. **222,226-229** (1989) (discussing an Office of the Comptroller of the Currency study of bank failures, a General Accounting Office study of bank and thrift failures, and a Federal Deposit Insurance Corporation study of bank failures); compare with LAWRENCE J. WHITE, THE SAVINGS AND LOAN DEBACLE: PUBLIC POLICY LESSONS FOR BANK AND THRIFT REGULATION **126-128** (1991) (attributing the largest set of failures to poor business judgments exacerbated by economic conditions, rather than to abuse). In addition, for an example of abusive transactions involving a savings and loan, see Lincoln Savings and Loan Assoc. v. Wall, **743 F. Supp. 901** (D.D.C. 1990) (describing, among other things, a series of transactions involving a savings and loan and its affiliates that resulted in the looting of the thrift). See also Catherine Yang with Dean Foust, *Disaster on a Watchdog's Doorstep*, Bus. WK, June 3, **1991**, **114** (describing loans to insiders at Madison National Bank).

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Thus, there is a need to maintain investor protection for transactions where abuses are likely to occur while eliminating review by the Commission for transactions that do not pose the same potential for abuse. Accordingly, the Division recommends some additional exclusions under section 17(d) but does not recommend any wholesale changes to the current regulatory system and specifically does not recommend any changes to section 17(a). We propose that rule 17d-1 be amended to permit the following joint transactions: (i) transactions with certain remote affiliates when certain conditions are satisfied, including approval of the directors; and (ii) transactions in which the investment company and any affiliate participate on identical terms except for the amount of their participation. We also propose that rule 10f-3 be amended to permit investment companies to participate in foreign offerings if certain conditions are satisfied that provide protections comparable to those provided by the current requirements.

### A. Section 17(a) and Riskless Principal Transactions

The Division does not recommend changes to section 17(a). We considered whether to recommend that the Commission exempt "riskless principal" transactions from section 17(a), and instead treat them like agency transactions under section 17(e). Under section 17(e) brokerage transactions with affiliates are permitted, subject to limits on the amount of compensation an affiliate may receive, depending on the market where the transaction is effected. For transactions effected on an exchange, the commission must not exceed the usual and customary broker's commission.<sup>36</sup> For transactions effected in connection with a secondary distribution, the commission may not exceed two percent of the sales price. For other transactions, such as over-the-counter trades and private placements, the commission may not exceed one percent of the sales price.<sup>37</sup>

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<sup>36</sup>Under rule 17e-1, which is a non-exclusive safe harbor for brokerage transactions with affiliates on an exchange, a commission will "be deemed as not exceeding the usual and customary broker's commission" if it is reasonable and fair compared to the fees received by other brokers, the board of the investment company has adopted procedures to monitor compliance with this standard and quarterly reviews compliance, and the investment company maintains records of its procedures and its transactions with affiliates. Disclosure of commissions paid to affiliated brokers is required by Item 17 of Form N-1A, Registration Form Used by Open-End Management Investment Companies; Guidelines, Investment Company Act Release No. 13436 (Aug. 12, 1983), 48 FR 37928 (requiring this disclosure in the Statement of Additional Information) and by Item 9 of Form N-2, 47 FR 39986,40047.

<sup>37</sup>Compliance with section 17(e) does not obviate the affiliate's duty to provide best execution. In proposing rule 17e-1, the Commission noted that "any transaction executed by an affiliated broker must satisfy also the investment company's obligation to obtain best price and execution in each securities transaction." Agency Transactions by Affiliated Persons on a Securities Exchange, Investment Company Act Release No. 10605, n.9 (Feb. 27, 1979), 44 FR 12202. See also (continued...)

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We do not recommend adopting a rule exempting riskless principal transactions because of the substantive differences between agency and riskless principal transactions. Even under a rule modeled on the safe harbor for affiliated broker's commissions under rule 17e-1, some conflicts of interest would remain. Moreover, it is difficult to monitor the execution provided by an affiliate in a riskless principal transaction and hence to determine whether the price and transaction costs meet standards comparable to those under section 17(e).

Riskless principal transactions typically are performed by dealers other than market makers in a security. They are unlike most principal transactions in that the dealer does not execute a customer's purchase or sale order from the dealer's existing inventory. Rather, the dealer executes the order by engaging in simultaneous transactions after locating a counterparty in the open market: the dealer purchases or sells the security from the customer for its own account and offsets that transaction with a simultaneous sale to, or purchase from, the counterparty.<sup>38</sup> Instead of a commission, the dealer typically receives a markup on the transaction. Riskless principal transactions are commonplace in some markets, particularly for transactions in debt securities.

Investment companies may not engage in riskless principal transactions with their affiliates, because such transactions involve the purchase or sale of securities by an affiliate acting as principal and are prohibited under section 17(a). Yet, in many respects, riskless principal transactions are functionally equivalent to brokerage transactions and may present less risk of overreaching than do typical principal transactions.<sup>39</sup> Most principal transactions present at least the possibility that the affiliated dealer may be "dumping" a security into an investment company to remove it from its inventory. In a true riskless principal

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<sup>37</sup>(...continued)

Delaware Management Co., Inc., 43 S.E.C. 392, 400 (1967) ("Persons engaged in the securities business cannot be unaware of their obligation to serve the best interests of customers, and that interpositioning is bound to result in increased prices or costs.") (citation omitted). Cf. Edgemont Asset Management Corp. and Bowling Green Securities, Inc., Investment Advisers Act Release No. 1280 (June 18, 1991), 49 SEC Docket 224 (settling administrative proceedings against an investment adviser and a broker regarding interpositioning in trades of fund's portfolio securities).

<sup>38</sup>This definition is drawn from rule 10b-10 (17 C.F.R. § 240.10b-10) under the Exchange Act, which requires broker-dealers to provide confirmations. Rule 15c3-1 under the Exchange Act also describes riskless principal transactions. 17 C.F.R. § 240.15c3-1(a)(2)(vi).

<sup>39</sup>Several commenters made this point in response to the Study Release. Letter from Fidelity Management & Research Company to Jonathan G. Katz, Secretary, SEC 8-9 (Oct. 11, 1990), File No. S7-11-90; Letter from the ICI to Jonathan G. Katz, Secretary, SEC 72-73 (Oct. 5, 1990), File No. S7-11-90; Letter from Prudential Mutual Fund Management to Jonathan G. Katz, Secretary, SEC 10-11 (Oct. 9, 1990), File No. S7-11-90.

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transaction, the dealer is not selling from inventory, but is acting essentially as an agent.

Riskless principal transactions do differ in some critical respects from agency transactions, however. A key difference is that in a riskless principal transaction the affiliated dealer deals directly with both the purchaser and seller, whereas in most agency transactions the broker does not have relationships with both parties. Thus, it is possible that a transaction might be initiated by an affiliate in order to dump overpriced securities as a favor to another customer.

Most significantly, it appears that monitoring price and execution for many riskless principal transactions is much more difficult than for agency transactions, in large part because of the lesser amount of information about the prices of fixed income securities. In contrast to the equity exchange markets, fixed income markets have few quotes and no trade information available to customers, so it is difficult to assess whether best execution occurred. In the government securities markets, the most reliable sources of information about current market prices are the interdealer brokers' screens, which only are available to primary and aspiring primary dealers. Other recently developed sources of quotes such as GOVPX are a promising beginning in improving the availability of price and quotation information on government securities but generally are not comprehensive.<sup>40</sup> Similarly, in the municipal securities markets, broker's brokers' quotes, such as those provided by Kenney S&P, are generally only available to bond dealers, and not to institutions. Finally, only some dealer quotes on corporate bonds and very limited price information concerning private mortgage-backed securities are available to investors on Telerate.

In addition, the legally mandated disclosure of markups or markdowns is limited, making it even more difficult to monitor the compensation paid in riskless principal transactions. Rule 10b-10<sup>41</sup> under the Exchange Act does not require disclosure of markups or markdowns by dealers in debt securities, nor does it require **such** disclosures for market makers in non-reported equity securities; instead, rule 10b-10 requires disclosure of markups or markdowns only

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<sup>40</sup>DEPARTMENT OF THE TREASURY, SEC, AND BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, JOINT REPORT ON THE GOVERNMENT SECURITIES MARKET B-87 to E 90 (1992).

<sup>41</sup>17 C.F.R. § 240.10b-10.

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for transactions by non-market makers in equity securities and transactions by any dealer in non-reported equity securities.<sup>42</sup>

For these reasons, enactment of a rule exempting riskless principal transactions from section 17(a) would not be feasible at present. There currently is not sufficient information available about prices and markups in riskless principal transactions that investment companies and their directors could comply with restrictions comparable to those in section 17(e) and the rule 17e-1 safe harbor for affiliated brokers' commissions.<sup>43</sup> Although a rule exempting all riskless principal transactions would not be appropriate at this time, the Commission might issue individual exemptive orders involving fund trades in high quality, liquid debt securities provided that applicants demonstrated that adequate information and safeguards existed.

## B. Section 17(d)

### 1. Approval by Directors of Joint Transactions with Remote Affiliates

The Division recommends permitting investment companies to engage in some affiliated transactions currently subject to section 17(d) with the approval of their directors, including their independent directors. The directors could approve specific affiliated transactions if they determined that each transaction met the relevant standards that must now be met for exemptive relief from the Commission. The elimination of the requirement of Commission approval would reduce the burden on investment companies and the Commission staff and the resulting expense and delay. Granting to directors the authority to approve some affiliated transactions makes sense if the group of transactions within their authority is sufficiently circumscribed that the risk of abuse is limited and the board can perform a meaningful review of each transaction. We propose

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<sup>42</sup>*Id.* In 1978, the Commission proposed amendments to rule **lob-10** that would have required disclosures of markups or markdowns received by dealers in debt securities, including municipal securities. Securities Confirmations, Securities Exchange Act Release No. **15220** (Oct. 6, 1978), **43 FR 47538**. The Commission withdrew this proposal in 1982. Securities Confirmations, Securities Exchange Act Release No. **18987** (Aug. 20, 1982), **47 FR 37919**. Those who opposed amending rule **lob-10** argued that disclosure of markups and markdowns was not material, since debt securities are usually priced by yield.

<sup>43</sup>For example, it would not be possible to determine whether a markup was reasonable and fair compared to those charged in other riskless principal transactions or to adopt and administer procedures designed to ensure compliance with such a standard.

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amending rule 17d-1 to permit directors to approve joint transactions with certain remote affiliates on a transaction-by-transaction basis.<sup>44</sup>

The restriction of director approval to transactions involving remote affiliates follows the line drawn in section 57(f), which permits directors of BDCs to approve transactions with those affiliates described in section 57(e).<sup>45</sup> This would allow directors to review joint transactions that Congress has determined create "generally less potential for actual overreaching and . . . generally less conflict between these persons and the directors who would be responsible for reviewing the proposed transaction."<sup>46</sup>

Consistent with the treatment of affiliated transactions in section 57(h), this authority should be accompanied by conditions designed to strengthen the independence and the fact gathering capabilities of the independent directors. Such conditions could include requirements that at least a majority of the fund's directors be independent,<sup>47</sup> fund directors adopt and periodically review and update procedures reasonably designed to prevent overreaching in transactions with affiliates, and detailed minutes be kept of meetings in which the independent directors consider transactions with affiliates. The exemption also

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<sup>44</sup>As discussed in the following section, the Division also recommends rulemaking to allow joint transactions where the fund and its affiliated persons do not participate on different terms, subject to periodic board review rather than transaction-by-transaction approval.

<sup>45</sup>The affiliates subject to this more streamlined procedure include: (1)any person who is an affiliated person by virtue of owning between five percent and **25%** of the shares of a BDC, or of being between five percent and **25%** owned by a BDC; (2) any officer or director of, or general partner in, any person specified in (1); (3) any person who directly or indirectly controls, is controlled by, or is under common control with any person specified in (1);and (4)with certain specified exceptions, any affiliated person of a director, officer, employee, investment adviser, member of an advisory board or promoter of, principal underwriter for, general partner in, or any affiliated person of any person directly or indirectly controlling or under common control with, a BDC.

<sup>46</sup>1980 SENATE REPORT, *supra* note 27, at 30. The Division recognizes that section 57(f) also permits independent directors of BDCs to approve purchases and **sales** of property to or from such remote affiliates acting as principal, but, as stated above, such relief would be inappropriate for investment companies.

<sup>47</sup>In Chapter 7, the Division recommends amending the Act to require all investment company boards **of** directors to have a majority of independent directors.

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might require that any fund seeking to rely on the exemption have self-nominating independent directors, as is now required for funds that have plans of distribution under rule 12b-1.<sup>48</sup>

The amendment should make clear that directors may engage outside experts to assist them in evaluating such transactions. While the use of independent experts would not be required, it is critical that the directors understand they have the authority to hire such experts as they deem necessary to judge the fairness of transactions and that, in some instances, such hiring may be necessary for the directors to meet their fiduciary obligations. Fund directors do not have the time or, in many cases, the capability to perform independent fact gathering. Thus, in reviewing affiliated transactions, they may be forced to rely on facts presented by the adviser unless they are able to hire personnel to gather facts for them.

The directors would have authority to approve only joint transactions, and not principal transactions under section 17(a), because there are significant differences between joint and principal transactions. All principal transactions squarely present potential conflicts of interest since the affiliate and the investment company are on opposite sides of the transaction. Joint transactions, by contrast, present less risk that securities are being "dumped" on an investment company by an affiliate. Joint transactions also appear better suited to review by the board because they would occur substantially less frequently than would principal transactions and in many cases would be easier to evaluate than principal transactions. Indeed, some commenters recommended that joint transactions under section 17(d) be permitted if approved by the independent directors of the investment company, but did not suggest this approach for principal transactions.<sup>49</sup>

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<sup>48</sup>17 CFR. § 270.12b-1. In Chapter 7, the Division also recommends amending section 10 of the Ad to require that all investment company boards of directors have self-nominating independent directors. Commenters that recommended board approval of joint transactions also suggested that such authority be subject to similar conditions. Letter from Ropes & Gray to Jonathan G. Katz, Secretary, SEC 11 (Oct. 9, 1990), File No. S7-11-90 [hereinafter Ropes & Gray Study Comment] (also suggesting that section 36(b), 15 U.S.C. § 80a-35(b), should apply to any participation in a joint transaction involving an adviser or principal underwriter or any of their affiliates); Letter from Debevoise & Plimpton, on behalf of the independent trustees of the Fidelity Funds, to Jonathan G. Katz, Secretary, SEC 6-7, 9 (Oct. 10, 1990), File No. S7-11-90 (also suggesting that independent directors have direct access to the fund's independent auditors; be represented by independent counsel; have periodic executive sessions; document proceedings in which they are involved; and, where appropriate, rely on information and advice furnished by independent auditors, counsel, or other appropriate consultants).

<sup>49</sup>See, e.g., Ropes & Gray Study Comment, supra note 48, at 11 .

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In addition, principal transactions require particular caution because they almost invariably carry the risk of overreaching. For example, if an investment company purchased a debt security from an affiliated market maker and, later, the issuer of the security defaulted, the affiliate could argue that the transaction was fair if it was done at fair market value, as determined by contemporaneous transactions with unrelated third parties. Nevertheless, it always remains open to question whether the investment company would have purchased the security at all if it were not for the affiliation. That is, transactions with affiliates at a "fair market price" may still compromise the unbiased nature of the portfolio management of the investment company.

#### **a. Director Approval of All Affiliated Transactions under Section 17**

The Division does not recommend that directors should have the authority to approve *all* affiliated transactions under section 17, including principal transactions and transactions with closer affiliates. Principal transactions in particular raise serious concerns, which we have discussed in the previous section. Moreover, we do not believe that general corporate law standards governing directors' conduct provide investor protection comparable to the current requirement of Commission approval. Some commenters had argued that the Commission should adopt exemptive rules permitting independent directors, at their option, to determine whether a particular transaction under section 17(a) or rule 17d-1 meets the relevant standards for exemption under the Investment Company Act.<sup>50</sup> In their view, since the enactment of the Act, state corporate law has become better developed as to the role of independent directors in policing possible self-dealing and overreaching by insiders.

While state laws dealing with corporate transactions in which a director or other affiliate has an interest have evolved considerably since 1940, the law has evolved in the context of operating companies, which typically have a very different management structure. The management of an operating company rarely is involved in running another business; accordingly, affiliated transactions

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<sup>50</sup>See, e.g., Letter from Dechert Price & Rhoads to Jonathan G. Katz, Secretary, SEC 7, 30-33 (Oct. 10, 1990, revised Oct. 15, 1990), File No. 57-11-90; see also Letter from Citicorp to Jonathan G. Katz, Secretary, SEC 25 (Oct. 10, 1990), File No. S7-11-90. This approach was suggested in 1976 by two Commission staff members. Alan Rosenblat & Martin E. 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, 634-51 (1976) (also suggesting subjecting service contracts (such as transfer agency, custodial, and accounting support contracts) to section 17(a), but exempting such contracts where a majority of the independent directors approve the contracts).

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tend to arise on a more limited basis and often only in the context of unusual corporate events, such as contests for corporate control.

By contrast, the management of an investment company usually is performed by another business enterprise that has its own pecuniary interest and also has other significant ongoing business operations that create numerous opportunities for transactions between affiliates and the investment company. For example, many investment companies are affiliated with broker-dealers or with other diversified financial services concerns having a wide range of investments and operations. In those interactions, the interests of the investment company and the affiliate often diverge. Accordingly, state law governing the decisions of corporate directors may not provide sufficiently specific standards for the directors' approval of numerous portfolio and other transactions on an ongoing basis.<sup>51</sup>

Moreover, because of the limitations on the information and time available, directors, and in particular the independent directors, could be overwhelmed if they were required to evaluate and approve a large number or wide range of affiliated transactions, particularly principal transactions. A typical investment company that is affiliated with a large broker-dealer might effect numerous principal transactions with the affiliated dealer, on a daily basis, absent the prohibitions of section 17. Asking fund directors to review numerous transactions is not only unrealistic, but might also interfere with the critical role independent directors play in overseeing the operations of the company by distracting their attention from broader issues. Indeed, the larger the number of transactions that the directors must review, the harder it would be for directors to scrutinize the merits of each transaction.

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<sup>51</sup>A related question in delegating such authority is whether section 36(b) should apply to director-approved affiliated transactions. Section 36(b) imposes a fiduciary duty on an investment company's investment adviser with respect to the amount of compensation received from the company by the adviser or an affiliate of the adviser; it currently does not apply to transactions subject to section 17, however. Subjecting director-approved affiliated transactions to section 36(b) would not provide sufficient additional protection to obviate the need for prior Commission review. To police overreaching effectively, the Commission's ability to bring actions under section 36(b) would have to be supplemented by private actions. It is unclear, however, how private parties would ever be able to monitor abusive transactions involving an investment company and its affiliates..

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## **2. Permitting Joint Transactions on an Equal Basis**

The Division also recommends amendments to rule 17d-1 to permit certain types of joint transactions by an investment company and its affiliates where the investment company participates on terms not different from those applicable to any affiliated participant.<sup>52</sup> Over the years, the Commission has issued a number of exemptive orders allowing investment companies and BDCs and certain affiliates to invest jointly in securities, if a number of conditions are met to ensure that the company's participation is on a basis not less favorable than any affiliate.<sup>53</sup> Those orders require, among other things, that the investment company and its affiliate purchase the same class of security at the same time and at the same price. They also have conditions concerning the timing of disposition of the security and typically require the independent directors of the investment company to review or approve such purchases.

Similarly, in the 1970s, the Commission proposed an amendment to rule 17d-1 to permit a practice known as "bunching," in which an investment company and its affiliates combine contemporaneous purchases or sales of securities of their various investment portfolios.<sup>54</sup> Commenters generally supported the proposal, but the Commission withdrew it in 1976, citing several concerns.<sup>55</sup> The Commission questioned whether the elimination of fixed commissions had eliminated the economic considerations supporting the exemption. The Commission also indicated that three questions raised by the rule would be better resolved on a case-by-case basis, through the consideration of exemptive applications: (1) whether bunching would be consistent with the fiduciary duties of affiliates; (2) whether affiliates could reap a disproportionate benefit; and (3) how to combine non-concurrent orders such as limit orders or partially executed orders. We have reevaluated those concerns and believe they can be

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<sup>52</sup>*Cf. Letter from R. James Gormley to Jonathan G. Katz, Secretary, SEC, attached memorandum at 14 (Oct. 24, 1990), File No. S7-11-90.*

<sup>53</sup>*One commenter suggested codifying these orders. Letter from The Equitable Life Assurance Society of the United States to Jonathan G. Katz, Secretary, SEC 25-27 (Oct. 5, 1990), File No. S7-11-90.*

<sup>54</sup>*Joint Enterprises or Arrangements and Certain Profit-sharing Plans, Investment Company Act Release No. 7035 (March 9, 1972), 37 FR 5831.*

<sup>55</sup>*Bunching Rule, Withdrawal of Proposal, Investment Company Act Release No. 9170 (Feb. 19, 1976), 41 FR 8799.*

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addressed in an exemptive rule, rather than by requiring individual applications for such transactions.<sup>56</sup>

In addition, some transactions exempted during the last few years share some of the characteristics of the bunching proposal and exemptive orders discussed above. The Division believes those transactions would similarly be amenable to regulation under an exemptive rule. For example, the Commission has exempted joint repurchase agreements, where two or more investment companies in the same complex jointly invest their excess cash in one or more repurchase agreements, resulting in cost savings and higher interest earned for each of the participating funds.<sup>57</sup> The Commission also has exempted the affiliates of several investment companies from rule 17d-1 to permit them to join in a lawsuit against the issuer of securities each of them held and share all legal fees and expenses in proportion to their respective securities holdings.<sup>58</sup>

These transactions do not present the risks that section 17(d) was designed to prevent: the participation by an investment company "on a basis different from or less advantageous than that of [any] other participant."<sup>59</sup> Rather, in each case, the investment company and its affiliates participate on the same terms, except as to the amount of their participation. Accordingly, the Division recommends an amendment to rule 17d-1 to permit any joint transaction where

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<sup>56</sup>One commenter suggested an amendment to rule **17d-1** to permit bunching of trades with affiliates, subject to five conditions: (1) the transaction involves only a cash payment against prompt delivery of a security; (2) the net price for the securities purchased or sold is the same to each participant; (3) the allocation of actual trades is substantially in proportion to the participants' orders; (4) the transaction is consistent with the investment company's policy; and (5) the investment company's board, including its independent directors, determines that transactions will be of benefit to the investment company. Letter from the American Council of Life Insurance to Jonathan G. Katz, Secretary, SEC **123-24** (Oct. 10, 1990), File No. **S7-11-90**. Similarly, another commenter recommended that the rule be amended to exempt "concurrent purchases or sales of portfolio securities by funds in the same complex." Letter from the Subcommittee on Investment Companies and Investment Advisers of the Committee on Federal Regulation of Securities, Section of Business Law, American Bar Association, to Jonathan G. Katz, Secretary, SEC **29** (Oct. 18, 1990), File No. **57-11-90** [hereinafter ABA Study Comment].

<sup>57</sup>See, e.g., ABT Growth and Income Trust, Investment Company Act Release Nos. **17626** (July 30, 1990), **55 FR 31933** (Notice of Application) and **17712** (Aug. 29, 1990), **46** SEC Docket **1990** (Order).

<sup>58</sup>See The Prudential Insurance Co. of America, Investment Company Act Release Nos. **17568** (July 3, 1990), **55 FR 28499** (Notice of Application) and **17644** (Aug. 2, 1990), **46** SEC Docket **1609** (Order).

<sup>59</sup>Rule 17d-1(b) (describing standard for Commission consideration of applications seeking approval of joint transactions).

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an investment company and its affiliates participate on equal terms, except for the amount of the participation. The exemption would require the board of the company, including a majority of the independent directors, to establish procedures to ensure that the transactions are within the exemption, and to determine periodically that the participation of the fund in the joint transactions continues to be in its best interest.

The Division believes that the amendment also should make clear that an exemption from section 17(d) and rule 17d-1 does not by itself address all questions under the Investment Company Act, other federal securities laws, or state laws. For example, it would not address whether an adviser to an investment company, as a **fiduciary**, is **obligated** to put the fund's trade ahead **of** its own or those of other clients.<sup>60</sup> Such concerns are not within the ambit of section 17(d), which allows the Commission to adopt rules to prevent participation by an investment company on a basis different from or less advantageous than that of other participants. Thus, if a transaction is on equal terms among the company and its affiliates, it is inconsistent with the purposes of the section to prohibit the transaction absent a Commission order, whether or not some other provision **of** law may prohibit joint participation. Therefore, the amendment would clarify, for example, that practices such as "bunching" are not prohibited under rule 17d-1, but may be subject to limitations under other legal standards.

### **3. Narrowing the Scope of Section 17(d) and Rule 17d-1**

The Division also considered three other ways to reduce the scope and attendant costs of the prohibition on joint transactions. One way would be to limit the prohibition to transactions where a fund and its affiliate are on the same side of the transaction, thereby excluding from the rule more complex arrangements. A second would be to reduce the number of affiliates subject to the prohibition. A third would be to replace rule 17d-1's application requirement with a rule that simply prohibits overreaching. As discussed below, we conclude that none of these proposals would provide adequate investor protection.

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<sup>60</sup>That question is not addressed by rule 17d-1 today. We note that section 17(j) and rule 17j-1 require funds and their advisers and principal underwriters to adopt codes of ethics governing securities trading by personnel with access to information about fund trading activities. Some codes of ethics require that such "access persons" effect all their trades in securities after fund trades. See, e.g., Mary Ann Tynan, *Drafting Guide for Codes of Ethics under Rule 17j-1*, ICI MUTUAL FUND TRAINING CONFERENCE, at IV-22 to IV-23 (1987).

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### **a. Prohibiting Only Participation on the Same Side of Transactions**

One way to clarify the scope of rule 17d-1 would be to limit its coverage to transactions where the investment company and an affiliate are on the same side. Two commenters recommended clarifying section 17(d) and rule 17d-1 in this manner.<sup>61</sup> One quoted a Commission brief that stated that section 17(d) applies to "a transaction in which the investment company and its affiliated person participate on the same side."<sup>62</sup> The other recommended amending rule 17d-1 to define a joint transaction as a transaction in which an affiliate "knowingly acts in combination with such registered investment company or a controlled company thereof in a manner that results in a potential sharing of the assets, liabilities, profits or losses of such enterprise or *undertaking*."<sup>63</sup> The commenter argued that "where parties are on opposite sides of the transaction it appears to 'negate the existence or possibility of "some element of combination" that the Second Circuit, in [Talley], said "is required" for purposes of Section 17(d) and rule 17d-1.'"<sup>64</sup>

Such a restricted definition of joint transactions would unduly narrow rule 17d-1. While it is true that section 17(d) often is described as applying to transactions where an investment company and its affiliate are "on the same side of the table transacting business with a third party,"<sup>65</sup> courts, the Commission, and the Commission's staff consistently have interpreted rule 17d-1 to apply where the affiliate and the fund are not on the same side of the table, but nevertheless have a joint interest in the transaction.<sup>66</sup> For example, in *Steadman*

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<sup>61</sup>ABA Study Comment, *supra* note 56, at 29; letter from Merrill Lynch & Co., Inc. to Jonathan G. Katz, Secretary, SEC 11-33 (Oct. 18, 1990), File No. S7-11-90 [hereinafter Merrill Lynch Study Comment].

<sup>62</sup>ABA Study Comment, *supra* note 56, at 29, quoting the Commission's brief in *SEC v. Tally Industries, Inc.*, *supra* note 13.

<sup>63</sup>Merrill Lynch Study Comment, *supra* note 61, at 11-32, -33, -38.

<sup>64</sup>*Id.* at 11-33, quoting Morgan Capital Corp. (pub. avail. Oct. 17, 1986). The commenter also suggested that inserting a "knowingly" requirement in the rule would help to clarify that actions such as simultaneous but independent investments are not prohibited. *Id.* We agree that this would not be a change from current law. (As noted earlier, section 57(a)(4) of the Act, concerning joint transactions by BDCs, has an express "knowingly" requirement.)

<sup>65</sup>See, e.g., LEMKE, *supra* note 31, at 83-136.

<sup>66</sup>See SEC v. Commonwealth Sec. Investors, Inc., [1970-71 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,859 (E.D. Ky. Oct. 21, 1970) (enjoining investment company insiders from future (continued..))

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*Security Corp.*,<sup>67</sup> the Commission, in determining that the controlling person of an adviser did not violate rule 17d-1 by having the fund maintain deposits at banks where he obtained personal loans, rejected the argument that section 17(d) applied only to joint ventures and observed that "three party transactions, such as those present here, would seem within section 17(d)'s scope were there a causal connection between the funds' deposits and [the controlling person's] loans."

The reasons for the Commission's position are obvious. As one writer put it:

Section 17(d) . . . was designed to deal with transactions of the investment company . . . in which affiliates have a conflict of interest. Congress was concerned with overreaching and unfair advantages to insiders. Conflict of interest and overreaching may exist whether or not the affiliates' participation is of the same economic nature. . . . [T]here are many examples in the Act's legislative history of investment companies that were induced to participate not only on different terms but in different economic arrangements. Investment companies' assets were used to finance companies and acquire control of enterprises in which affiliates had personal interests. Investment companies were operated as discretionary brokerage accounts to produce commissions for affiliates. They were used to manufacture securities for promoters in the securities distribution business.<sup>68</sup>

The concerns of the 1940 Congress about overreaching and unfair advantage to insiders are equally relevant today. Indeed, those joint transactions reviewed by the Commission in which the fund and an affiliate do not participate on the same side of the table often involve complex business arrangements. Our experience in reviewing such arrangements suggests that close examination continues to be necessary, especially for those transactions where an investment company and an affiliate will experience different economic consequences.

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<sup>66</sup>(...continued)

violations of rule 17d-1 based on their obtaining loans, securities, and fees from a company with which the investment company was negotiating a merger); *South Bay Corp.* (pub. avail. Dec. 4, 1974) (declining to provide no-action assurance regarding settlement of lawsuit by registered investment company against officers and directors of 45% shareholder of investment company).

<sup>67</sup>*Supra* note 16.

<sup>68</sup>2 TAMAR FRANKEL, THE REGULATION OF MONEY MANAGERS, ch. XIII, § 24.3, at 531-32 (1980 & Supp. 1991) (citations omitted).

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### b. Narrowing the Group of Affiliates Subject to the Rule

Another way to reduce the uncertainty about the scope of rule 17d-1 would be to reduce the number of affiliates brought within its prohibitions. One commenter recommended amending rule 17d-1 to apply only to transactions where the affiliate is an investment adviser, principal underwriter, or controlling person with respect to the company.<sup>69</sup> Thus, joint transactions with relatively close affiliates such as controlling persons of fund advisers and principal underwriters and with fund officers and directors would be lawful, without any restriction even though such affiliates may still be in a position to exercise significant influence over an investment company. By contrast, in enacting section 57, which permits independent directors of BDCs to approve transactions with remote affiliates, Congress did not accept that such relatively close affiliates presented a reduced risk of overreaching or conflict of interest.

Transactions with many of these relatively close affiliates are as susceptible to overreaching and abuse as are transactions directly with fund advisers and underwriters. Indeed, some of the leading precedents under section 17(d) involve the affiliates that would be excluded under this proposal. For example, in *SEC v. Midwest Technical Development Corporation*,<sup>70</sup> a mutual fund made heavy investments in certain portfolio companies sorely in need of financing. The court found that the investments had been induced by the fund's directors, who had assisted in the organization of the companies. After the strengthening of the financial structure of the portfolio companies by the fund's investments, the directors made their own investments.

In light of those risks, we do not recommend so great a narrowing of the scope of rule 17d-1. We recommend instead, as discussed above, amending rule 17d-1 to make it parallel to the requirements of section 57. Thus, fund directors would have the authority to approve only joint transactions with those more remote affiliates that Congress has determined present little risk of abuse.

### c. Prohibiting Only Overreaching

The Division also considered whether to alter the regulation of joint transactions radically by amending rule 17d-1 to prohibit only those joint transactions that involve overreaching. This idea was proposed in 1971 by two

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<sup>69</sup>Letter from the Committee on Securities Regulation of the Association of the Bar of the City of New York to Jonathan G. Katz, Secretary, SEC 2-3 (Oct. 4, 1990), File No. S7-11-90.

<sup>70</sup>[1961-64 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 91,252 (D. Minn. July 5, 1963).

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trade associations representing insurers.<sup>71</sup> They suggested that, instead of requiring prior Commission approval, the Commission rely on enforcement actions under an amended rule 17d-1 and section 36(a). The Commission did not pursue this suggestion then, and we do not recommend that it do so now.

Relying on after-the-fact enforcement action to address overreaching would give investment companies and their affiliates the opportunity to do improper transactions subject only to the risk of subsequent and probably incomplete enforcement. It is doubtful that any enforcement could provide a full remedy, because it would be difficult and time-consuming to undo improper affiliated transactions. Even if a transaction could be undone and a fund could be compensated, such actions would not compensate shareholders harmed by the improper transaction who may have redeemed in the interim. For such a rule to be effective, the Division would have to monitor carefully all joint transactions through its examination process -- an impossibility and an extremely intrusive prospect.

### C. Section 10(f) and Rule 10f-3

The Division also recommends that rule 10f-3 be expanded to permit investment company purchases of foreign securities that are not currently exempt under the rule from the section 10(f) prohibition on purchases from syndicates containing affiliates.<sup>72</sup> Funds that invest overseas generally are unable to rely on rule 10f-3 because it requires that the securities being purchased either be registered under the Securities Act or be municipal securities. Obviously, in most cases, neither alternative can be satisfied in an overseas offering. The Commission has met that problem by exempting investment companies where the

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<sup>71</sup>Memorandum of American Life Convention and Life Insurance Association to the Division of Corporate Regulation, SEC (Feb. 11, 1971). One author also discussed this approach in 1972:

Under [section] 17(d) we might consider a self-operating lob-5 type rule, making overreaching in joint transactions unlawful, rather than the cumbersome application procedure. A blanket exemptive rule could be adopted covering situations where there is an absence of overreaching. This would replace the existing application procedure with a self-operating approach such as that reflected by rule lob-5 under the [Exchange] Act.

Milton P. Kroll, *The 'Portfolio Affiliate' Problem*, in THIRD ANNUAL INST. ON SEC. REGULATION, 261, 290-91 (PLI Sec. Reg. Transcript Series No. 3, 1972).

<sup>72</sup>Comments on rule 10f-3 mostly focused on the inability of funds that invest overseas to rely on the rule. See, e.g., Letter of Davis Polk & Wardwell to Jonathan G. Katz, Secretary, SEC 33-34 (Oct. 10, 1990), File No. 57-11-90; Letter of S.G. Warburg & Co. Inc. to Jonathan G. Katz, Secretary, SEC 6-8 (Oct. 12, 1990), File No. S7-11-90.

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company represented that the securities regulation of the country in which the company was to purchase securities was "substantially equivalent for purposes of rule 10f-3."<sup>73</sup> This substantial equivalence standard, however, is not attainable in emerging markets that are subject to less regulation than the home market.

Since neither the registration requirement of rule 10f-3 nor the "substantial equivalence" standard of exemptive orders provides relief in markets that cannot meet those requirements, we recommend that rule 10f-3 be amended specifically to permit investment companies to purchase foreign securities in compliance with restrictions that would provide protections comparable to those provided by the current requirements.<sup>74</sup> These might include requirements that the offering be a public offering<sup>75</sup> conducted in accordance with applicable law and that the offering be conducted by means of a firm commitment underwriting.<sup>76</sup> The conditions would also require that audited financial statements of the issuer for the most recent three years be available to prospective purchasers, to ensure that adequate public information is available to the investment company and its adviser and directors to facilitate their review of the investment merit of such securities. These requirements would retain safeguards against "dumping," while removing an unnecessary barrier to portfolio transactions in foreign securities.

#### **IV. Conclusion**

The Act's restrictions on transactions with affiliates are among its core provisions. Recent experience has reaffirmed the wisdom of the Act's drafters in imposing those restrictions. Accordingly, we recommend only limited changes in this area. We recommend that the Commission begin rulemaking proceedings to amend rule 17d-1 to permit the directors, including the independent directors, to review and approve all joint transactions with remote affiliates and also to

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<sup>73</sup>See, e.g., The Japan Fund, Inc., Investment Company Act Release Nos. 9789 (June 6, 1977), 42 FR 29351 (Notice of Application) and 9832 (June 24, 1977), 12 SEC Docket 1087 (Order).

<sup>74</sup>It appears that the Commission imposed the registration requirement in rule 10f-3 to ensure that the investment company purchased marketable securities, at the public offering price, which ordinarily would not exist absent registration. Registration also tends to ensure that the securities offering is in the ordinary course of business.

<sup>75</sup>We understand, however, that in certain foreign markets public offerings are not conducted at a uniform offering price. A public offering requirement would need to address the issues raised by non-uniform pricing, and especially by the existence of distinct prices for affiliates.

<sup>76</sup>We note that in Japan initial public offerings are bifurcated into two portions, only one of which is on a firm commitment basis. The other portion includes an auction procedure.

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permit all joint transactions where the investment company and its affiliates participate on the same terms, except for the amount of the participation; and amend rule 10f-3 to provide relief for purchases overseas similar to that extended to purchases in domestic markets.

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## Chapter 13

# Procedures for Exemptive Orders

### I. Introduction and Summary of Recommendations

The Commission is accorded significant discretion to administer the provisions of the Investment Company Act.<sup>1</sup> In at least thirty-three separate instances, the Act authorizes the Commission to issue orders for different types of relief from specific statutory requirements? The quintessential discretionary provision is section 6(c),<sup>3</sup> which authorizes the Commission to:

conditionally or unconditionally exempt any person, security, or transaction, or any class or classes of persons, securities, or transactions, from any provisions of [the Act] or of any rule or regulation thereunder, if and to the extent that such exemption is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of [the Act]?

Congress, in its foresight, added this section to provide the Commission with administrative flexibility?

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<sup>1</sup>Investment Company Act of 1940, 15 U.S.C. § 80a.

<sup>2</sup>Investment Company Act §§ 2(a)(9), 3(b)(2), 8(f), 9(c), 10(e)(3), 10(f), 11(a), 12(g), 15(f)(3), 16(a), 17(b), 17(e)(2), 18(i), 18(j), 19(b), 22(b)(1), 22(e)(3), 23(b), 23(c)(1), 23(c)(3), 26(b), 27(b), 28(b), 28(d), 31(d), 34(a), 38(a), 56(b), 57(c), 57(j)(2)(E)(ii), 57(k), 57(n)(1)(A)(ii), 61(a)(3)(B)(i), 15 U.S.C. §§ 80a-2(a)(9), -3(b)(2), -8(f), -9(c), -10(e)(3), -10(f), -11(a), -12(g), -15(f)(3), -16(a), -17(b), -17(e)(2), -18(i), -18(j), -19(b), -22(b)(1), -22(e)(3), -23(b), -23(c)(1), -23(c)(3), -26(b), -27(b), -28(b), -28(d), -30(d), -33(a), -37(a), -55(b), -56(c), -56(j)(2)(E)(ii), -56(k), -56(n)(1)(A)(ii), -60(a)(3)(B)(i). In addition, the Commission also issues exemptive orders under rule 17d-1 to permit the consummation of joint transactions involving affiliates otherwise prohibited by section 17(d) and rule 17d-1 thereunder. 17 C.F.R. § 270.17d-1. See Chapter 12.

<sup>3</sup>15 U.S.C. § 80a-6(c).

<sup>4</sup>In addition, section 6(b) authorizes the Commission to exempt employees' securities companies from one or more of the Act's provisions, section 6(d) authorizes the Commission to exempt certain small, closed-end, intrastate investment companies from any or all of the Act's provisions, and section 6(e) authorizes the Commission, in exempting any investment company from the registration provisions of section 7 (15 U.S.C. § 80a-7), to impose conditions of compliance with any of the Act's provisions.

<sup>5</sup>In his remarks to Congress recommending the bill that later became the Investment Company Act, David Schenker, Chief Counsel of the Commission's Investment Trust Study and a principal (continued...)

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Despite the flexibility of section 6(c), however, responses to the Commission's release soliciting comments on the reform of investment companies (the "Study Release"),<sup>6</sup> criticized section 6(c) and particularly the Commission's and the Division's administration of the provision.<sup>7</sup> While many commenters declared that the flexibility provided by section 6(c) is indispensable to the success of the Act,<sup>8</sup> many of the same commenters also complained that the process of obtaining an exemptive order simply takes too long.<sup>9</sup> Commenters also criticized

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<sup>5</sup>(...continued)

author of the Act, stated that "the difficulty of making provision for regulating an industry which has so many variants and so many different types of activities . . . is precisely [the reason that section 6(c)] is inserted." *Investment Trusts and Investment Companies: Hearings on S. 3580 Before a Subcomm. of the Senate Comm. on Banking and Currency*, 76th Cong., 3d Sess. 197 (1940) [hereinafter 1940 Senate Hearings].

<sup>6</sup>Request for Comments on Reform of the Regulation of Investment Companies, Investment Company Act Release No. 17534 (June 15, 1990), 55 FR 25322.

<sup>7</sup>See, e.g., Letter from the Subcommittee on Investment Companies and Investment Advisers of the Committee on Federal Regulation of Securities, Section of Business Law, American Bar Association ("ABA Subcommittee"), to Jonathan G. Katz, Secretary, SEC 5-9 (Oct. 18, 1990), File No. S7-11-90 [hereinafter ABA Study comment]; Letter from Davis Polk & Wardwell to Jonathan G. Katz, Secretary, SEC 40-44 (Oct. 10, 1990), File No. S7-11-90 [hereinafter Davis Polk Study Comment]; Letter from Dechert Price & Rhoads to Jonathan G. Katz, Secretary, SEC 5, 11-17 (Oct. 10, 1990), File No. S7-11-90 [hereinafter Dechert Price Study Comment]; Letter from Federated Investors to Jonathan G. Katz, Secretary, SEC 26 (Oct. 10, 1990), File No. S7-11-90 [hereinafter Federated Study Comment]; Letter from Fidelity Management & Research Co., Inc. to Jonathan G. Katz, Secretary, SEC 9-10 (Oct. 11, 1990), File No. S7-11-90 [hereinafter Fidelity Study Comment]; Letter from IDS Financial Corporation to Jonathan G. Katz, Secretary, SEC 25-27 (Oct. 2, 1990), File No. S7-11-90 [hereinafter IDS Study Comment]; Letter from the Investment Company Institute ("ICI") to Jonathan G. Katz, Secretary, SEC 44-46 (Oct. 5, 1990), File No. S7-11-90 [hereinafter ICI Study Comment]; Letter from Merrill Lynch & Co., Inc. to Jonathan G. Katz, Secretary, SEC 1-4, Ex. I (Oct. 18, 1990), File No. S7-11-90 [hereinafter Merrill Lynch Study Comment]; Letter from PaineWebber Development Corporation to Jonathan G. Katz, Secretary, SEC 4 (Oct. 10, 1990), File No. S7-11-90 [hereinafter PaineWebber Study comment]; Letter from Prudential Mutual Fund Management, Inc. to Jonathan G. Katz, Secretary, SEC 8-9 (Oct. 9, 1990), File No. S7-11-90 [hereinafter Prudential Study Comment].

'According to Alfred Jaretzki, Jr., one of the principal authors of the Act, "Without these exemptive powers and without a wise exercise of discretion thereunder, the Act would be unworkable, unduly restrictive and would cause unnecessary hardships." Alfred Jaretzki, Jr., *The Investment Company Act of 1940*, 26 WASH. U. L.Q. 303,344 (1941). Several responses to the Study Release shared Mr. Jaretzki's view. See, e.g., ABA Study Comment, *supra* note 7, at 6; Davis Polk Study Comment, *supra* note 7, at 40-41 n. 57; ICI Study Comment, *supra* note 7, at 44-45; PaineWebber Study Comment, *supra* note 7, at 3 n.\*.

<sup>9</sup>See, e.g., ABA Study Comment, *supra* note 7, at 7 (recounting the experience of one of its members, stating that "whereas [the member] once advised clients to expect that an order could be issued in four to six months he now advises one to two years."). Critics have focused on  
(continued...)

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the Division for a perceived reluctance to exercise its delegated authority<sup>10</sup> in granting exemptive orders,<sup>11</sup> and a perceived narrow interpretation of section 6(c).<sup>12</sup>

Because of the importance of the application procedure to the administration of the Act, the Division examined a number of options for reform, either through changes to the substantive standards in the statute or through procedural changes. We considered a number of alternatives, including the suggestions made by commenters. We conclude that while existing standards and procedures are fundamentally sound, they may be improved.

Our first recommendation for procedural reform is of our own creation, although it draws on certain of the recommendations made by commenters. The procedure we propose would permit expedited treatment of applications for which there is precedent. Applicants employing this procedure generally would receive relief no later than 120 days after filing an application. (Currently, on average, applicants receive orders approximately 190 days after filing.) Our second recommendation is an amendment to the Division's delegated authority that we believe would expedite review of applications. We discuss these recommendations, as well as the approaches we considered and rejected, below.

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<sup>9</sup>(...continued)

perceived unnecessary delays in the review of relatively routine applications (see, e.g., IDS Study Comment, *supra* note 7, at 26) as well as those presenting novel and complex issues (see, e.g., ABA Study Comment, *supra* note 7, at 7-9; Davis Polk Study Comment, *supra* note 7, at 41-42; Fidelity Study Comment, *supra* note 7, at 9; IDS Study Comment, *supra* note 7, at 26), and have argued that these delays make it difficult to obtain exemptive orders within the time frame required to accommodate a specific transaction, which may prevent worthwhile financial products from entering the marketplace, to the detriment of investors.

<sup>10</sup>See *infra* notes 36 & 46 and accompanying text.

<sup>11</sup>See, e.g., ABA Study Comment, *supra* note 7, at 7-9; Merrill Lynch Study Comment, *supra* note 7, at 2-3.

<sup>12</sup>See, e.g., Davis Polk Study Comment, *supra* note 7, at 41-42; Dechert Price Study Comment, *supra* note 7, at 11-16; IDS Study Comment, *supra* note 7, at 26; Merrill Lynch Study Comment, *supra* note 7, at 2; PaineWebber Study Comment, *supra* note 7, at 3-4.

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## II. Background

### A. The Historical Use of Section 6(c)

Early opinions of the Commission emphasized that use of its exemptive authority was to be somewhat limited.<sup>13</sup> As the financial markets have evolved, however, the need for exemptive relief has grown, not only to respond to new innovations but also to keep pace with the general evolution of the investment company industry.<sup>14</sup> The orders issued by the Commission have addressed matters ranging from relatively minor investment company operational matters to complex trading vehicles that do not necessarily fit within the regulatory confines of the Act.

Perhaps the most powerful example of the flexibility and scope of the Commission's authority under section 6(c) is the introduction and growth of money market funds. Under section 2(a)(41), registered investment companies must value their securities based on market values, if available, or, if not, values determined in good faith by the board of directors. In a series of exemptive orders beginning in the 1970's, the Commission permitted money market funds to use two alternative valuation methods, amortized cost or penny rounding.<sup>15</sup> Those orders were later codified in rule 2a-7.<sup>16</sup> The orders and the rule were critical to the evolution and success of money market funds, which, as of year-end 1991, represented approximately \$450 billion in assets and about 33% of all mutual fund assets.<sup>17</sup>

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<sup>13</sup>In a 1941 opinion, the Commission stated that "[t]he very breadth of a power to exempt any person, security, or transaction from any provision of the Act places upon us a grave responsibility that such power be exercised with the greatest circumspection." *In re American Participations, Inc.*, 10 S.E.C. 430,437 n.8 (1941). See also *In re Atlantic Coast Line Company*, 11 S.E.C. 661,667 (1942) (construing section 6(c) as authorizing relief only in those "special situations that might have been overlooked or that could not be foreseen at the time the legislation was drafted").

<sup>14</sup>The extent to which the Commission and the financial services industry now depend on the exemptive process is demonstrated by the number of applications reviewed by the Division. In recent years, the number received has fluctuated somewhat, but is always substantial, ranging from 415 in fiscal year 1989 to 347 in fiscal year 1990 to 310 in fiscal year 1991.

<sup>15</sup>See generally Valuation of Debt Instruments and Computation of Current Price Per Share By Certain Open-End Investment Companies (Money Market Funds), Investment Company Act Release Nos. 12206 (Feb. 1, 1982), 47 FR 5428 (request for comments on proposed rule 2a-7) and 13380 (July 11, 1983), 48 FR 32555 (notice of final rule 2a-7).

<sup>16</sup>17 C.F.R. § 270.2a-7.

<sup>17</sup>See ICI News Release, ICI 92-03 (Jan. 29, 1992).

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In the last several years alone, the Commission's exemptive orders have covered a wide variety of Investment Company Act issues. For example, many relate to new sales and distribution practices in the mutual fund industry, such as offers of exchange among investment portfolios in the same family of funds;<sup>18</sup> imposition of contingent deferred sales loads,<sup>19</sup> and more complicated matters such as funds offering multiple classes of shares with different sales charges and expenses.<sup>20</sup>

Recent Commission orders also have involved somewhat narrow but complicated factual circumstances. For example, in 1989, as part of its settlement with Drexel Burnham Lambert Inc. ("Drexel"), the Commission issued an order under section 9(c) of the Act temporarily allowing Drexel to remain as an adviser and principal underwriter to a number of registered investment companies, notwithstanding the automatic disqualification in section 9(a). The order contained a number of conditions, including a requirement that Drexel hire an independent examiner to conduct an extensive review of its investment company operations.<sup>21</sup>

Another exemptive order involving a complex factual situation is the 1990 Commission order permitting a unit investment trust to issue redeemable equity interests that are divided into two unredeemable components.<sup>22</sup> The order exempted the trust, its sponsor, and dealers from section 22(d) of the Act, thereby permitting the trust's securities to be traded freely on secondary markets.<sup>23</sup>

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<sup>18</sup>See, e.g., PNCG Money Market Fund, Inc., Investment Company Act Release Nos. **16971** (May 19, 1989), **54 FR 23000** (Notice of Application) and **17007** (June 14, 1989), **43** SEC Docket **2059** (Order). Orders of this type now have been codified in rule **11a-3**. **17** C.F.R. § **270.11a-3**.

<sup>19</sup>See, e.g., Freedom Investment Trust, Investment Company Act Release Nos. **16487** (July 20, 1988), **56 FR 56260** (Notice of Application) and **16526** (Aug. 16, 1988), **41** SEC Docket **904** (Order).

<sup>20</sup>See, e.g., Goldman Sachs--Institutional Liquid Assets, Investment Company Act Release Nos. **17420** (Apr. 11, 1990), **55 FR 14541** (Notice of Application) and **17479** (May 8, 1990), **46** SEC Docket **350** (Order).

<sup>21</sup>Drexel Burnham Lambert Inc., Investment Company Act Release No. **17133** (Sept. 11, 1989), **44** SEC Docket **1104**.

<sup>22</sup>The SuperTrust Trust for Capital Market Fund, Inc. Shares, Investment Company Act Release Nos. **17613** (July 25, 1990), **55 FR 31281** (Notice of Application) and **17809** (Oct. 19, 1990), **47** SEC Docket **1098** (Order).

<sup>23</sup>*Id.* In addition, as discussed in Chapter 1, the Commission has issued a number of orders in recent years exempting certain types of structured financings from the provisions of the Act.

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## B. Current Procedures for Obtaining Exemptive Relief under Section 6(c)

Applicants seeking exemptive relief under section 6(c) must file an application with the Commission setting forth a basis for the relief requested (including a detailed justification for removal of any statutory protections), and identifying any benefits expected for investors and any conditions imposed to protect investors.<sup>24</sup> Applications are reviewed in the order received, unless the applicant makes a compelling demonstration that the application could not have been filed in time to allow it to be addressed and acted upon in due course.<sup>25</sup> The total time period for consideration of an exemptive application by the staff and (in some instances) the Commission, responses by the applicant, and the notice period typically ranges from six to eight months, depending on the novelty and complexity of the requested relief and the staff's workload. During the review process, the staff may send comment letters to the applicant requesting clarifications or modifications to the application to assure that the requested relief is consistent with statutory standards.<sup>26</sup> Once review of an application is completed, a notice outlining the requested relief is published in the *Federal Register* to give interested persons an opportunity to request that the matter be set down for a hearing.<sup>27</sup> After a notice period of approximately twenty-five

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<sup>24</sup>Commission guidelines require prospective applicants to review all relevant provisions of the Act and rules thereunder, and all pertinent Commission releases, before filing an application. Applicants are also required, to the extent possible, to bring their proposal within applicable precedent, and to cite and discuss such precedent in the application. Commission Policy and Guidelines for Filing of Applications for Exemption, Investment Company Act Release No. **14992** (Apr. 30, 1985), 50 FR **19339** (setting forth procedures and guidelines for applicants to follow in connection with filing exemptive applications, and representing the Commission's efforts to streamline the exemptive applications process in response to increases in the early **1980's** in both the number and complexity of exemptive applications filed under section 6(c)).

<sup>25</sup>*Id.* § 6/50 FR at **19340**.

<sup>26</sup>Division guidelines require the staff to give initial comments on an exemptive application within **45** days of receipt of the application (*id.* at n.1, 50 FR at **19339** n.1) and the applicant to file any amendments to its application within 60 days of receipt of staff comments (*id.* § 8/50FR at 19340). At the staff's discretion, an applicant who does not file an amendment within 60 days may be placed on inactive status. *Id.* An applicant may reactivate an inactive application at any time by filing an appropriate request with the Division or **by** filing the required amendment. *Id.* Action on reactivated applications commences from the date of **the** Division's receipt of such an such request or amendment, and does not date back to the filing of the original application. *Id.*

<sup>27</sup>Under section 40(a) of the Act, orders of the Commission may be issued only after appropriate notice and opportunity for hearing. 15U.S.C. § 80a-39(a). Division guidelines require that notices of routine applications which require no amendment be published within 60 days of receipt of the application. Inv. Co. Act Rel. **14492**, *supra* note **24**, at n.1, 50 FR at **19339** n.1.

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days,<sup>28</sup> and unless a hearing is requested by an interested party or is ordered by the Commission on its own motion, an order is issued granting the requested relief.<sup>29</sup> If the staff determines that it cannot support an application because the relief requested is not justified, it may recommend that the application be withdrawn.<sup>30</sup> If the Division is unwilling to support an application, and it is not withdrawn, the Division submits the application to the Commission with a recommendation that it be set down for a hearing.<sup>31</sup> The Division does not have delegated authority to order hearings or deny applications.<sup>32</sup>

### **III. Recommendations to Expedite Review of Exemptive Applications**

Because of the importance of the exemptive process and the significant Commission resources involved, the Division has re-examined both the statutory basis for exemptive orders and the Commission's own procedures to determine if either could be improved.<sup>33</sup> Among other things, the Division hoped to identify a means to shorten the time period for the issuance of orders or withdrawal of applications, because of our concern that, at times, the process is unnecessarily lengthy. At the same time, we sought to avoid imposing on the Commission unnecessarily short time frames for resolving all requests for exemptive relief, given the complexity and significance of many applications.<sup>34</sup>

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<sup>28</sup>The Act does not specify the duration of the notice period. However, under the Federal Register Act, the notice period generally must last for at least 15 days after publication. 44 U.S.C. § 1508. Because of this 15 day requirement and because of the fact that notices generally are not published in the *Federal Register* for at least six days after the notice is issued, the Commission typically provides that the opportunity to request a hearing extends for between 25 and 28 days from the date of issuance.

<sup>29</sup>Internal Division guidelines also require that orders granted under delegated authority be issued within two business days after the expiration of the notice period. Inv. Co. Act. Rel. 14492, *supra* note 24, at n.1, 50 FR at 19339n.1.

<sup>30</sup>*Id.* § 3, 50 FR at 19340.

<sup>31</sup>*Id.* at n.3, 50 FR at 19340 n.3.

<sup>32</sup>This authority is not granted to the Division Director under the rules governing delegated authority. 17 C.F.R. § 200.30-5(a)(1), (2).

<sup>33</sup>See *supra* notes 6 & 7 and accompanying text.

<sup>34</sup>A number of the other recommendations in the Division's study should reduce the need to rely on the Commission's exemptive authority. See, e.g., Chapter 1 (exemptive rule for structured financings); Chapter 12 (amendments to rules 10f-3 and 17d-1 to reduce the scope of the prohibitions imposed by these rules) (17 C.F.R. §§ 270.10f-3, .17d-1); and Chapter 2 (new exception (continued...)

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## A. Expedited Procedures for Applications Based on Precedent

Our primary recommendation incorporates certain of the commenters' suggestions. It would establish a procedure that would decrease the amount of time required for consideration of applications that are controlled by precedent, while also incorporating appropriate safeguards.<sup>35</sup> Essentially, it would provide for expedited review of applications that are based on recent precedent, if the applicant complied with certain procedural requirements. The procedure we propose would be available only with respect to applications seeking relief from those provisions of the Act for which the Division has been granted delegated authority to issue notices and orders,<sup>36</sup> and only for those applicants who specifically request it. In addition, because our proposal would continue to require publication of a notice of application and would afford opportunity for a hearing, it would comply with section 40(a) of the Act. Consequently, the proposal could be implemented by a change in the Commission's procedures and would not require a statutory amendment.

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<sup>34</sup>(...continued)

For issuers whose securities are owned exclusively by qualified purchasers). We nevertheless believe that some changes to the applications procedures also are warranted.

<sup>35</sup>In response to the Study Release (*supra* note 6), several commenters recommended procedures providing for expedited treatment of applications for which there is precedent. Some commenters recommended that all applications seeking relief similar to that which the Commission has granted previously, and containing the same conditions as the precedential application, be deemed granted after 30 days if the Commission does not take affirmative action to prevent the exemption. See Fidelity Study Comment, *supra* note 7, at 9; ICI Study Comment, *supra* note 7, at 45-46; Prudential Study Comment, *supra* note 7, at 9. These proposals could **only** be implemented through legislation. One commenter recommended, for applications "where there is precedent for the issues involved, and where applicants represent that there are no material differences of fact [from the precedential application], that exemptions be automatically granted after 60 days unless the staff indicates that it has concerns." IDS Study Comment, *supra* note 7, at 26. Another commenter suggested a slightly different approach, recommending that the Commission adopt a procedure for expedited treatment of exemptive requests where the application is accompanied by a certificate of independent fund counsel to the effect that the application is clearly supported by precedent and does not raise any material issues not addressed in a previous Commission order, including orders granted by delegated authority. Dechert Price Study Comment, *supra* note 7, at 16-17.

<sup>36</sup>17 CFR. § 200.30-5(a)(1), (2). For a discussion of the Division Director's delegated authority, see *infra* note 46. As discussed below in Section III.B., we recommend that the Division's delegated authority be expanded to include all exemptive provisions of the Act. If this proposal were implemented, there would be no limitation concerning the provisions of the Act to which the expedited procedures described above would apply.

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Our proposal is comprised of the following elements:

**a. Counsel Certification:** Investment company counsel would be required to certify that the application is consistent with the two most recent applications relied on as precedent, the most recent of which was issued within the last two years, and that such application contains all of the same conditions and material representations as the most recent precedential application. In addition, the applicant would be required to provide, as exhibits to its application, a copy of the application marked to show changes from the most recent precedential application and a draft notice marked to show changes from the Commission notice issued in connection with that application.<sup>37</sup> Counsel also would certify the accuracy of these exhibits.<sup>38</sup>

**b. Notice Within Ninety Days of Filing:** A notice of application would issue no later than ninety days of the filing of the application, unless the Division informed the applicant prior to that time that the application would not be handled under expedited procedures, but instead would be considered under regular review procedures. The Division would have complete discretionary authority to make this determination, which would not be subject to review.<sup>39</sup> The notice, which would be published in the Federal Register, would inform the public that, unless an interested party requests a hearing within the notice period (twenty-five to twenty-eight days), or the Commission orders a hearing on its own motion, an order will be issued.

**c. Order Within 120 Days of Filing:** An application satisfying the criteria of paragraph (a) above that is handled in accordance with the time periods set forth in paragraph (b) would be granted no later than 120 days after filing (or thirty days after issuance of the notice), unless a request for a hearing were filed in response to the notice of application published in the Federal Register, or the Commission ordered a hearing on its own motion.

While an expedited procedure runs the risk of overwhelming the Division's resources, we believe that there are sufficient safeguards built into the proposal to diminish that risk significantly.

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<sup>37</sup>A number of law firms already provide copies of applications and draft notices marked to show changes from prior precedent.

<sup>38</sup>Compare the proposed procedures with the approach suggested by Dechert Price & Rhoads, discussed *supra* note 35.

<sup>39</sup>The circumstances under which an application would be reviewed under regular procedures are discussed *infra* note 41 and accompanying text.

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First, we envision that the proposed procedure would be used only for applications that are clearly governed by precedent. While Division staff assigned to applications for which expedited treatment is requested would still have to find that the particular application did or did not conform with precedent, the required certifications by fund counsel and marked copy of the application and notice would provide some assurance that such is indeed the case.

Moreover, the Division would have a full ninety days to review the application and decide whether it is and should be controlled by the precedent cited.<sup>40</sup> If the Division believed that the application did not conform to, or was not controlled by, the precedent cited, or determined that the precedent relied on should not have precedential value or should be modified in future orders, it would inform the applicant that the application would be decided under regular application procedures.<sup>41</sup>

In addition, the requirement that the precedential order have been issued within the last two years would ensure that no "stale" precedent was relied on and that the Division would have some familiarity with the relief sought. More significantly, the Division's position on issues often evolves based on new information about the operation of particular types of exemptions. Because of the limited staff available to review applications, however, the Division rarely recommends that the Commission institute proceedings to revoke orders. Without the requirement that the precedent relied on be recent, and the staff's discretion to remove an application from expedited consideration, the expedited procedure could result in the granting of exemptive applications that merit fresh consideration.<sup>42</sup>

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<sup>40</sup>The proposed procedures also may have to take into account the impact of staff comment letters on the time limits prescribed in our recommendation. While we envision that comment letters will be infrequent, the Division may on occasion have questions or comments in connection with applications that appropriately qualify for expedited treatment under our proposal. One option would be to provide that comment letters toll the 90 day period. Additionally, or alternatively, the procedure could require ~~an~~ applicant to respond within a reasonable amount of time (e.g., 30 days) or the 90 day period would begin anew.

<sup>41</sup>While, as noted in the text above, the Division's determination would not be reviewable, it is contemplated that these would be the only circumstances under which a *particular* application otherwise eligible for expedited treatment would be reviewed under regular procedures. The Division, however, would have the authority to suspend the availability of the expedited procedure in response to resource needs, although we expect this would happen rarely, if at all.

<sup>42</sup>One alternative to the "recent precedent" approach would be for the Division to publish a list **of** applications that could not be relied on for expedited treatment. Given present staffing constraints, however, such an approach is unrealistic.

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Finally, while we recognize that there is potential for abuse in the expedited procedure we propose, we believe we have diminished that potential through the required certifications of counsel and the requirement that the applicant provide as exhibits copies of the application and draft notice reflecting any changes from the precedent relied on. In connection with the required certifications, section 34(b) of the Act, which prohibits the making of misleading statements in filings under the Act, including applications, will apply. In addition, if counsel were to certify in a misleading manner, it might be grounds for a Commission disciplinary proceeding under rule 2(e) of the Commission's Rules of Practice.<sup>43</sup> In formulating the expedited treatment procedures, we also intend to consider whether additional, less drastic disciplinary procedures might be appropriate.<sup>44</sup>

We believe that our proposal would achieve the desired goal of enabling applicants seeking non-controversial relief based on established precedent to receive an exemption on a predictable and expedited basis.<sup>45</sup> Our proposal also provides the Division with the flexibility to require that an application be reviewed under regular procedures to avoid the possibility that an order would be issued based on mistaken precedent as well as to allow the Division's analysis with respect to the conditions and representations necessary for a particular type of exemptive relief to evolve. For these reasons, we recommend its implementation. Because staff resources are limited, however, the Commission should recognize, that the need to meet the time periods imposed by the recommended procedure could divert resources from novel and complex applications.

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<sup>43</sup>17 C.F.R. § 201.2(e).

<sup>44</sup>By way of analogy, under rule 487, which provides for expedited effectiveness of registration statements for certain series of unit investment trusts, the Commission may suspend indefinitely a registrant's eligibility for expedited treatment. 17 C.F.R. § 230.487. The Commission has delegated that authority to the Division Director. 17 C.F.R. § 200.30-5(b-3).

<sup>45</sup>We contemplated other approaches that utilized prior exemptive applications as precedent. For example, we considered implementing a procedure whereby applicants seeking expedited review of precedented applications would receive a "temporary" or time limited order within 60 days of filing (unless the staff determined that application would not be handled under expedited procedures) and a permanent order within 180 days of filing. During the temporary relief period, the staff could require amendments incorporating additional and/or modified conditions and representations. We envisioned that this approach would permit applicants to obtain relief quickly (even more quickly than under our recommended approach), but would also afford the staff the opportunity to "fine tune" applications before a permanent order was entered. We decided against recommending this approach, however, because of a concern that applicants would not find temporary relief helpful in most cases. An applicant proceeding with a proposed transaction, for example, would remain vulnerable to possible modification of its operations to satisfy conditions arising under the permanent order. In addition, we sought a relatively simple procedure.

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## B. Amendments to the Division's Delegated Authority

We believe that delay on some applications may be caused by an unnecessarily narrow delegation of authority from the Commission to the Division Director.<sup>46</sup> Currently, the delegation of authority requires the Division Director to present to the Commission all applications involving any matter that has not been previously settled by the Commission, even if the matter does not raise investor protection or public interest concerns.<sup>47</sup> Because we believe that this standard is unnecessarily restrictive, we recommend that Commission rules governing the delegation of authority be amended to incorporate a concept of materiality in connection with the determination of whether a particular matter appears to present issues not previously settled by the Commission.<sup>48</sup>

Moreover, there are several exemptive provisions of the Act for which the Division Director has not been granted delegated authority to issue notices or orders.<sup>49</sup> Because we can discern no principled basis for distinguishing these

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<sup>46</sup>The Division Director has delegated authority to issue notices where, "upon examination, the matter does not appear to [her] to present issues not previously settled by the Commission or to raise questions of fact or policy indicating that the public interest or the interest of investors requires that a hearing be held." 17 CFR. § 200.30-5(a)(1). The Division Director is similarly permitted to "authorize the issuance of orders where a notice . . . has been issued and no [timely]request for a hearing has been filed by an interested person . . . and the matter involved presents no issue that [s]he believes has not previously been settled by the Commission and it does not appear to [her] to be necessary in the public interest or the interest of investors that a hearing be held." 17 CFR. § 200.30-5(a)(2) (emphasis added).

<sup>47</sup>*Id.*

<sup>48</sup>In response to the Study Release (*supra* note 6), the **ABA** Subcommittee and Merrill Lynch & Co., Inc. both maintained that the Division has been unduly narrow in exercising its existing delegated authority, although neither cited a specific example. **ABA** Study Comment, *supra* note 7, at 7-9; Merrill Lynch Study Comment, *supra* note 7, at 1-11 to 1-14. For applications not decided under delegated authority, the **ABA** Subcommittee also charged that the Commission review procedure, including specifically the preparation and use of internal memoranda regarding particular applications and the Division's recommendation with respect thereto, is unduly time consuming and formalistic. **ABA** Study Comment, *supra* note 7, at 9. We simply disagree. We believe that the Division has exercised its authority appropriately and that the Commission review procedure works well.

<sup>49</sup>This category includes section 2(a)(9) (Commission may determine that applicant **has** rebutted presumption of control); section 15(f)(3) (Commission shall consider asset size in determining whether to exempt transaction from the certain provisions of section 15(f)(1)); section 18(i) (Commission may permit issuance of stock by registered investment company that is not voting stock with rights set forth in that section); section 19(b) (Commission may permit distribution of long-term capital gains more often than once every twelve months); section 22(b)(1) (Commission may "make due allowance" and grant "appropriate qualified exemptions" from (continued...)

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exemptive provisions from others for which delegated authority has been granted, we recommend that they be added to list of provisions included in the delegation. Under our proposal, the delegation would be amended to read as set forth in Appendix 13-A at the end of this chapter.

## IV. Other Options Considered

### A. Automatic Effectiveness for All Applications Absent Commission Action

We considered a more radical change to the Commission's exemptive procedures: amending the Act to provide that all exemptive applications become automatically effective within a fixed period of time unless the Commission takes action to stop effectiveness.<sup>49</sup> As noted by commenters supporting an automatic effectiveness rule,<sup>50</sup> such a change would make the Investment Company Act's exemptive procedures resemble provisions of the Securities Act governing the effectiveness of registration statements,<sup>51</sup> and provisions under the Exchange Act

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<sup>49</sup>(...continued)

provisions of section 22 when it appears that small companies are subject to relatively higher operating costs); section 27(b) (Commission may relax sales load requirements on registered investment companies that issue periodic payment plan certificates); section 28(b) (Commission may authorize as "qualified investments" for face amount certificate companies investments other than those defined in section 28(b)); section 28(d) (for face amount certificate companies, Commission may permit deferment of payment to a certificateholder other than deferment of the type and for the period specified in the subsection); section 34(a) (Commission may permit destruction or alteration of documents otherwise required to be preserved); section 38(a) (Commission may make, issue, amend, or rescind orders necessary or appropriate to the exercise of its powers, including rules and regulations defining accounting, technical, and trade terms, and prescribing the form in ~~which~~ information required for registration statements, applications, and reports to the Commission shall be set forth); section 56(b) (Commission may exempt business development companies ("BDCs") from requirements relating to director qualifications); and section 57(j)(2)(E)(ii) (Commission may approve loans by BDCs to certain directors or partners otherwise prohibited by sections 57(a) and (d)).

<sup>50</sup>Federated Investors, the ICI, and Prudential Mutual Fund Management all recommended that applications under section 6(c) be automatically granted 90 days after filing unless the Division or Commission takes some action to stop effectiveness. Federated Study Comment, *supra* note 7, at 1-2; ICI Study Comment, *supra* note 7, at 45-46; Prudential Study Comment, *supra* note 7, at 9.

<sup>51</sup>See IDS Study Comment, *supra* note 7, at 26 (regarding the procedures attending the review of proxy statements and post-effective amendments under the federal securities laws); ICI Study Comment, *supra* note 7, at 46 n.38 (regarding the processing of applications under section 4(c)(8) of the Bank Holding Company Act of 1956).

<sup>52</sup>These provisions are discussed *infra* note 55.

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regarding the use of proxy materials.<sup>53</sup> We believe that such an approach would be seriously flawed, for several reasons.

We believe that a procedure that sets an inflexible time period for responding to all types of exemptive applications without regard to their novelty or complexity, or to the volume of applications and the Commission's staffing levels, would be unrealistic. These factors are largely outside the Commission's control. Moreover, trends in federal spending indicate that it is very uncertain whether the Commission would be able to devote sufficient resources so that *all* applications would be reviewed adequately within ninety days.

Moreover, if this approach were implemented,<sup>54</sup> it is likely that the practice would evolve into a procedure much like the one that now exists regarding the effectiveness of registration statements under the Securities Act. Although the Securities Act provides that registration statements become effective in twenty days unless the Commission issues a stop order<sup>55</sup> in practice a large percentage contain the "delaying amendment" language prescribed in rule 47.<sup>56</sup>

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<sup>53</sup>Rule 14a-6, 17 C.F.R. § 240.14a-6. The procedures for review of proxy materials generally permit an issuer whose preliminary proxy statement has been on file for 10 days to mail such materials to shareholders without first receiving notice or comments from the Division. If the Division has or will have comments on a preliminary proxy statement, it must advise the issuer promptly, and in no event later than the tenth day. Proxy statements become "automatically effective" when the solicitation concerns only those matters specified in rule 14a-6(a) under the Securities Exchange Act of 1934. *Id.*

<sup>54</sup>Unlike our recommended procedure, this approach would require a statutory amendment.

<sup>55</sup>Section 8(a) of the Securities Act provides that registration statements become effective in 20 days unless the Commission issues an order under either section 8(b) or 8(d). Securities Act of 1933, 15 U.S.C. § 77h(a), (b), (d). Procedures governing the review of post-effective amendments to registration statements filed by investment companies are set forth in rule 485 of Regulation C, 17 C.F.R. § 230.485. Under rule 485(a), post-effective amendments usually become effective on the 60th day after filing, although the Commission (and the Division Director, by delegation) has the authority to declare an earlier effective date. Under paragraph (b) of rule 485, post-effective amendments filed for certain limited purposes (*e.g.*, to increase the number or amount of securities proposed to be offered under section 24(e)(1) of the Investment Company Act (15 U.S.C. § 80a-24(e)(1)) may become effective on the date on which the amendment is filed, if certain conditions are satisfied. The Commission (and the Division Director, by delegated authority) may suspend a post-effective amendment prior to its effective date if it appears that the amendment may be incomplete or inaccurate in any material respect. 17 C.F.R. § 230.485(c). Following such action, the registrant may petition the Commission for review of the suspension. *Id.* The Commission will order a hearing on the matter if such a request is included in the petition. *Id.*

<sup>56</sup>Rule 473 of Regulation C, 17 C.F.R. § 230.473.

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and do not become effective until the staff has completed its review.<sup>57</sup> Absent the equivalent of a delaying amendment, we believe that the system proposed would not be workable. With the equivalent of a delaying amendment, we do not believe that the proposal would be effective in expediting the review of exemptive applications.

In evaluating the propriety of any automatic effectiveness procedure, it is also important to recognize that section 6(c) of the Investment Company Act requires the Commission to determine whether and the extent to which a requested exemption is necessary and appropriate in the "public interest" -- a term that is not defined under the Act -- and is consistent with the "protection of investors" -- also undefined -- and the "policies and provisions" of the Act. Each determination requires the Commission not only to apply two flexible standards, but also may require a determination of consistency with the purposes of any one or more of the Act's sixty-five sections, and with the policies underlying the statute.

In this regard, we note that there is a critical distinction between allowing Securities Act registration statements and their amendments to become effective by the simple passage of time, and deeming exemptive applications to be granted on the same basis. In the first situation, a statutory obligation is imposed on the issuer to provide appropriate disclosure of material information.<sup>58</sup> Such obligation continues even after the registration statement has become effective and any staff review has been completed.<sup>59</sup> In contrast, approval of an exemptive application, which consists of both fact and legal argument, requires the Commission to apply the relevant statutory standards and make the required determination. Once granted, the "exempted" transaction or product may proceed with no ensuing liability for the applicant.<sup>60</sup>

In sum, given the broad authority in section 6(c) to exempt any person from any provision of the Act, the flexible standards governing such determinations, and the consequences of the granting of exemptive relief, we

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<sup>57</sup>For a description of this practice and its evolution, see LOUIS LOSS, **FUNDAMENTALS OF SECURITIES REGULATION** 122-25 (1988 & Supp. 1991).

<sup>58</sup>Securities Act §§ 11(a), 12, 17(a), 15 U.S.C. §§ 77k(a), 77l, 77q(a).

<sup>59</sup>See generally LOUIS LOSS AND JOEL SELIGMAN, **SECURITIES REGULATION** 3519-3525 (3d ed. 1991) (discussion of the duty to update and the duty to correct statements made in Commission filings and otherwise in connection with the sale of securities).

<sup>60</sup>Under section 38(c), no liability under the Act attaches "to any act done or omitted in good faith in conformity with any rule, regulation, or order of the Commission, notwithstanding that such rule, regulation, or order may, after such act or omission, be amended or rescinded or be determined by judicial or other authority to be invalid for any reason." 15 U.S.C. § 80a-37(c).

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believe it would be inappropriate for all types of applications presumptively to be granted unless the Commission takes affirmative action to stop the application.

## B. Dispensing with Prior Notice for Routine Applications

In the Study Release, the Commission specifically noted the **1984** recommendation of the Task Group on Regulation of Financial Services ("Task Group") that "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."<sup>61</sup> As indicated above, we support the essence of the Task Group's recommendation, which is to shorten the review process. We believe that this objective would be achieved by the expedited procedures we recommend. In addition, our proposal does not require a statutory amendment.

We note that notices of applications form a body of law and administrative practice that is very valuable to investment company sponsors and their counsel, as well as to the Division. If the Act were amended to remove the prior notice requirement, we believe that it still would be necessary to draft and issue orders that summarized the substance of an application, so that the public would know of Commission regulatory decisions.

Finally, removing the notice requirement would have its costs. From time to time, the Commission receives hearing requests, which may result in the applicant amending its application or in a hearing. If prior notices were not given, interested persons, uninformed of Commission action, would be forced to seek any redress in court; such an outcome likely would result in less efficient resolution of their concerns.

## C. Substantive Changes to Section 6(c)

Commenters also suggested substantive changes to the Commission's exemptive authority.<sup>62</sup> One recommended that section 6(c) be amended to include expressly the ability to balance perceived costs of regulation to investors against any benefits accruing from an exemption.<sup>63</sup> That commenter cited two

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<sup>61</sup>Study Release, *supra* note 6, at 8 n.8. This recommendation was endorsed in the Dechert Price Study Comment, *supra* note 7, at 16, and the IDS Study Comment, *supra* note 7, at 27.

<sup>62</sup>Dechert Price Study Comment, *supra* note 7, at 11-16; Federated Study Comment, *supra* note 7, at 1; Merrill Lynch Study Comment, *supra* note 7, at Ex. I.A.

<sup>63</sup>Dechert Price Study Comment, *supra* note 7, at 15-16. To achieve this result, the commenter recommended adding the following sentence at the end of section 6(c): "In interpreting its authority under this subsection with respect to any section or rule, the Commission may take into (continued..)

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recent orders of the Commission as evidence that the Commission has already used section 6(c) in such a manner, but the commenter expressed concern that the legislative history of the provision and the Commission's own early interpretations cast some doubt on this approach.<sup>64</sup> The recommended amendment purportedly would protect against challenges to the Commission's authority.

We do not recommend this amendment to section 6(c) because we believe that it is unnecessary. As the commenter noted, the Commission has treated investment flexibility, diversification, and cost to investors as appropriate elements for consideration under section 6(c).<sup>65</sup> We believe that the broad statutory authority granted to the Commission by section 6(c) permits the Commission to consider these factors.

Another commenter argued that:

During the last few years, . . . it **has** become evident that the Commission staff is developing a new and severely restrictive view of Section 6(c). Under that approach, the exemptive authority **of** the Section does not reach certain provisions of the 1940 Act so that applications for exemption from those provisions do not warrant substantive consideration.<sup>66</sup>

To remedy this perceived problem, the commenter suggested adding the following sentence at the end of the section 6(c): "No provision of this title shall be construed as limiting the Commission's authority to grant exemptions under this subsection."<sup>67</sup>

We agree that section 6(c) empowers the Commission to exempt persons from every section **of** the Act, limited only by the requirement that the exemption

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<sup>63</sup>(...continued)

account the estimated costs to investors of regulation under such section or rule as compared with the benefits to investors reasonably contemplated from granting an exemption." Id. at 16.

<sup>64</sup>*Id.* at 12-14.

<sup>65</sup>*Id.* at 14-15.

<sup>66</sup>Merrill Lynch Study Comment, supra note 7, at I-1. Another commenter apparently shares this view, stating that it "particularly takes issue with the proposition that certain provisions of the 1940 Act are automatically precluded from the possibility of exemptive relief due to the manner in which the statutory language is constructed." ABA Study Comment, supra note 7, at 5.

<sup>67</sup>Merrill Lynch Study Comment, supra note 7, at 1-2

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be in the public interest and consistent with the protection of investors and the purposes **of** the Act. While we believe that any consideration of an application under section 6(c) necessarily must be informed by a careful examination of the purpose(s) of the particular provision from which the applicant seeks relief, we do not believe that there are sections of the Act from which the Commission may not grant exemptions. Accordingly, we do not believe the suggested amendment is necessary.<sup>68</sup>

Finally, two commenters, while not suggesting substantive statutory amendments to section 6(c), recommended that the Commission issue a release clarifying its interpretation of the section's statutory standards!<sup>69</sup> We do not agree with this proposal for a number of reasons.

Determinations under section 6(c) are made on a fact-specific basis. In our view, any attempt to define section 6(c) standards outside a specific factual context would not be fruitful and might unnecessarily limit the Commission's flexibility in the future.

Moreover, to the extent that it is possible to make statements of general applicability concerning section 6(c)'s standards, we believe that the Commission has already done so. In the Study Release, for example, the Commission indicated:

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]." 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 . . ." 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. . ." The Commission believes that the tripartite test set forth in section 6(c) provides the Commission with

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<sup>68</sup>In the Study Release (*supra* note 6), the Commission rejected the idea that its power under section 6(c) was limited because a particular provision prohibited certain conduct. See text accompanying note 70 below.

<sup>69</sup>Davis Polk Study Comment, *supra* note 7, at 42-44; PaineWebber Study Comment, *supra* note 7, at 4.

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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?"

Lastly, we believe that an interpretive release is unnecessary. In our view, the Commission's interpretation of its authority under section 6(c) is discernible from its prior exemptive orders.

#### **D. Increased Use of Rulemaking Authority**

While we believe that the proposed procedural changes and the suggested amendment to the Division's delegated authority would expedite the review of exemptive applications, we also believe that the greatest improvement to exemptive procedures would be for the Division to develop, and the Commission to adopt, exemptive rules more quickly -- in short, for the development and adoption of rules based on well-established precedent to become a more routine part of the Division's and Commission's work. Consequently, we recommend an increased allocation of Division personnel to rulemaking activities.<sup>70</sup>

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<sup>70</sup>Study Release, *supu* note 6, § IV (footnotes omitted).

"Somewhat analogously, some commenters suggested that the Commission make increased use of its authority under section 6(c) to exempt "classes of persons, securities, or transactions" and to grant "% road, class-based exemptions" in situations where it appears likely that a particular exemption would benefit persons in addition to the applicant. Davis Polk Study Comment, *supa* note 7, at 41-42; Letter from Davis Polk & Wardwell to Jonathan G. Katz, Secretary, SEC (June 14, 1990), File No. S7-11-90 (supplementing Oct. 10, 1990 Davis Polk Letter re class exemptions); PaineWebber Study Comment, *supra* note 7, at 3-4. The ICI recommended that, failing adoption by the Commission of its suggestions concerning substantive modifications to the Act, the Commission should "be provided the authority to grant class exemptions with respect to each of [its] specific proposals." ICI Study Comment, *supra* note 7, at 45 n.37. We believe that a class-exemption order is unwise as a matter of policy. Procedures required in connection with the issuance of orders are not well-suited to crafting industry-wide standards. Notices of applications are designed to present the terms of the exemption solely for a particular applicant. Only "interested persons" (as that term is defined in the Act) may present their views (17 CFR. § 270.0-5(a)) and only by requesting a hearing (*id.*). In our view, rulemaking procedures are much better suited to address matters of general applicability. Notices of proposed rulemaking are designed to inform a wide range of persons on the broad policy issues presented. Any person may comment simply by writing a letter. 5 U.S.C. § 553(c). Finally, unlike an exemptive order, an exemptive rule is codified in the Code of Federal Regulations and other compilations of agency rules (5 U.S.C. § 553(d)), giving affected persons much clearer notice of the agency's determinations. While we believe that the Commission could modify its procedures for exemptive orders so that the procedures would be better suited to eliciting helpful public comment, such changes would simply have the effect of turning case-by-case adjudications into rulemaking proceedings. We see no discernible benefit from such a result.

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The Commission should be aware, however, that because rulemaking takes time, any **such** shift in personnel may not result in an immediate improvement in the number of pending applications or in a reduction in the average amount of time required for an application to be noticed and ordered. Over time, however, we believe that the increased focus on rulemaking would lead to a significant decrease in the number of applications filed, with a resulting improvement in both backlog and the time period required for applications review.

## **V. Conclusion**

In our view, major changes to either the Commission's substantive authority or its procedures are unnecessary. While we support a procedural modification, as well as some modifications to the Division Director's delegated authority, we believe that the most significant way to reduce the backlog of applications is to amend the Act to remove unnecessary provisions and to adopt exemptive rules more quickly.

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## APPENDIX 13-A

### **Red-Lined Version of Proposed Amendments to Rule 30-5 of the Rules Delegating Functions to Division Directors, Regional Administrators and the Secretary of the Commission**

**(new language is shaded; deleted language is struck through)**

**Rule 30-5.** Pursuant to the provisions of Public Law No. 87-592, 76 Stat. **394** [15 U.S.C. 78d-1, 78d-2], the Securities and Exchange Commission hereby delegates, until the Commission orders otherwise, the following functions to the Director of the Division of Investment Management, to be performed by him or under his direction by such person or persons as may be designated from time to time by the Chairman of the Commission:

(a) With respect to the Investment Company Act of 1940 [15 U.S.C. 80a-1, et seq.]:

(1) To issue notices, pursuant to Rule 0-5(a), with respect to applications for orders under ~~the following sections of~~ the Act and the rules and regulations promulgated thereunder and, with respect to Section 8(f) of the Act, in cases where no application has been filed, where, upon examination, the matter does not appear to him to present ~~material issues not previously settled by the Commission or to raise~~ questions of fact or policy indicating that the public interest or the interest of investors ~~warrants consideration of the matter by the Commission, requires that a hearing be held.~~

- (i) ~~Section 3(b)(2), 15 U.S.C. 80a-3(b)(2);~~
- (ii) ~~Section 6(b), 15 U.S.C. 80a-6(b);~~
- (iii) ~~Section 6(c), 15 U.S.C. 80a-6(e);~~
- (iv) ~~Section 6(d), 15 U.S.C. 80a-6(d);~~
- (v) ~~Section 6(e), 15 U.S.C. 80a-6(e);~~
- (vi) ~~Section 7(d), 15 U.S.C. 80a-7(d);~~
- (vii) ~~Section 8(f), 15 U.S.C. 80a-8(f);~~
- (viii) ~~Section 10(e), 15 U.S.C. 80a-10(e);~~

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- (ix) Section 10(~~n~~, 15 U.S.C. 80a-10(f);
- (x) Section 11(a), 15 U.S.C. 80a-11(a);
- (xi) Section 12(g), 15 U.S.C. 80a-12(g);
- (xii) Section 15(f)(3), 15 U.S.C. 80a-15(f)(3);
- (xiii) Section 17(b), 15 U.S.C. 80a-17(b);
- (xiv) Section 17(d), 15 U.S.C. 80a-17(d);
- (xv) Section 17(e), 15 U.S.C. 80a-17(e);
- (xvi) Section 17(f), 15 U.S.C. 80a-17(f);
- (xvii) Section 17(j), 15 U.S.C. 80a-17(j);
- (xviii) Section 18(j), 15 U.S.C. 80a-18(f);
- (xix) Section 23(b), 15 U.S.C. 80a-23(b);
- (xx) Section 23(c), 15 U.S.C. 80a-23(c);
- (xxi) Section 26(b), 15 U.S.C. 80a-26(b);
- (xxii) Section 28(e), 15 U.S.C. 80a-28(e);
- (xxiii) Section 31(d), 15 U.S.C. 80a-30(d);
- (xxiv) Section 32(j), 15 U.S.C. 80a-31(e);
- (xxv) Section 45(a), 15 U.S.C. 80a-44(a);
- (xxvi) Section 57(e), 15 U.S.C. 80a-56(e);
- (xxvii) Section 57(j), 15 U.S.C. 80a-56(j);
- (xxviii) Section 57(k), 15 U.S.C. 80a-56(k);
- (xxix) Section 57(n), 15 U.S.C. 80a-56(n); and
- (xxx) Section 61(a)(3), 15 U.S.C. 80a-60(a)(3).

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(2) To authorize the issuance of orders where a notice, pursuant to Rule 0-5(a), has been issued and no request for a hearing has been received from any interested person within the period specified in the notice and it appears to him that the matter involved presents no material issue that he believes has not previously been settled by the Commission and it does not appear to him to be necessary in the public interest or the interest of investors that the Commission consider the matter a hearing be held;