

**MEMO# 3795**

May 20, 1992

## **SEC ISSUES STAFF REPORT ON INVESTMENT COMPANY REGULATION**

May 20, 1992 TO: BOARD OF GOVERNORS NO. 37-92 SEC RULES MEMBERS NO. 19-92  
CLOSED-END FUND MEMBERS NO. 25-92 INVESTMENT ADVISER MEMBERS NO. 23-92 SMALL  
FUNDS MEMBERS NO. 8-92 UNIT INVESTMENT TRUST MEMBERS NO. 33-92 RE: SEC ISSUES  
STAFF REPORT ON INVESTMENT COMPANY REGULATION

The Securities and Exchange Commission today issued a staff report prepared by the Division of Investment Management entitled "Protecting Investors: A Half Century of Investment Company Regulation." The Report includes the Division's legislative and regulatory recommendations on changes to the Investment Company Act of 1940 and provisions of other federal securities laws regulating investment companies. The Report incorporates many of the comments the Institute submitted in connection with the staff's study. (See Memorandum to SEC Rules Members No. 70-90, Members-One Per Complex No. 44-90, Closed-End Fund Members -One Per Complex, Unit Investment Trust Members - One Per Complex, dated October 9, 1990). The Institute is sponsoring a special one-day conference on the recommendations included in the Report on Tuesday, June 23 at the Grand Hyatt Hotel in Washington, D.C. Details on the conference are being sent under separate cover. Set forth below is a summary of the staff's recommendations included in the Report. A copy of the Report is attached. The Scope of the Investment Company Act A. Asset-Backed Arrangements - The Division recommends that the Commission adopt a rule exempting asset-backed arrangements from the Investment Company Act, subject to conditions intended to address investor protection concerns presented by these arrangements. The Division's proposal recommends requiring that (1) the issuer hold only "eligible assets" as defined in the Report (essentially, debt instruments), (2) the issuer primarily hold the assets to maturity or for the life of the issuer, (3) the issuer does not issue any redeemable securities, (4) all of the issuer's securities sold to public investors be fixed-income securities rated in one of the two - 1 - highest investment grade categories, and (5) the issuer's assets not needed for servicing be held in a segregated account by a qualified trustee or custodian. B. Private Investment Company Exceptions - The Report includes several of the recent proposals submitted by the SEC to Congress as part of its small business initiatives. These proposals include (1) amending the Investment Company Act to add a new exception for investment companies whose securities are owned exclusively by such "qualified purchasers" as designated in Commission rulemaking, (2) amending Section 3(c)(1) (the private investment company exemption) to simplify the existing shareholder attribution provision for applying the 100 investor limit therein, and (3) amending Section 12(d)(1) to make both private investment companies and the new "qualified purchaser" pools subject to the limitations therein governing purchases of securities of registered investment companies. C. Pooled Investment Vehicles for Employee Benefit Plan Assets - The Division

recommends that the Commission propose amending the Securities Act of 1933 to repeal the exemption from registration for interests in pooled funding vehicles for participant-directed defined contribution plans and to require the delivery of prospectuses to plan participants who direct their investments. In addition, the staff recommends amending the federal securities laws to require the delivery of semiannual and annual shareholder reports for the underlying investment vehicles, including investment companies, to such plan participants.

**Cross-Border Sales of Investment Management Services**

**A. Internationalization and Investment Companies** - The Division recommends that the Commission propose amending Section 7(d) to permit operating foreign investment companies to sell shares in the U.S. if they can demonstrate that they are subject to regulation in their home country that serves the same purposes as the investor protection provisions under the Investment Company Act and that permitting their entrance into the U.S. markets would be in the public interest. 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 the country in which the operating foreign investment company is organized, which would set forth representations about the nature and extent of foreign regulation. The Division believes that the memorandum of understanding procedure would address the concerns expressed by the Institute about the barriers facing U.S. funds when offering shares abroad since the memoranda "would provide a mandate for bilateral access to each country's market." - 2 - In addition, the Division suggests that the Commission support tax law changes to enable U.S. funds securing access to foreign markets to compete effectively with foreign investment companies and continue to work with state regulators to eliminate duplicative substantive regulation of investment companies, which would ease compliance burdens for both domestic and foreign funds.

**B. The Investment Advisers Act of 1940** - With respect to the applicability of the Advisers Act to an adviser's activities in connection with its foreign clients, the Division proposed issuing no-action letters narrowing the applicability of the Act in those instances in accordance with a "conduct" and "effects" approach. Under this approach, a registered foreign adviser's dealings with clients outside of the U.S. generally would not be regulated under the Act. However, a registered domestic adviser's dealings with foreign clients where a sizable amount of adviser conduct occurs in the U.S. would be subject to the Act.

**C. Performance Based Advisory Compensation** - The Division recommends that the Commission propose amending the Advisers Act to grant the Commission rulemaking authority to allow U.S. registered advisers to enter into performance fee contracts with (1) non-U.S. clients to the extent that these compensation arrangements are lawful in the clients' home jurisdiction and (2) clients who the Commission determines by regulation do not need the protections of the prohibition, based on factors such as wealth and financial sophistication.

**Regulation of Investment Companies**

**A. Investment Company Governance** - The Division recommends that the Commission 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 vacancies be filled by the remaining independent directors. The Division's proposal also would give the independent directors the authority to terminate advisory agreements. In addition, as recommended by the Institute, the staff proposes that the Commission amend certain rules under the 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.

**B. Shareholder Voting Requirements** - The Division recommends that the Commission propose amending the Act to eliminate requirements that shareholders ratify the initial advisory agreement, concur in the board's selection of fund auditors, or approve changes in relatively routine investment policies. The Division also recommends that the Act be amended to classify as

fundamental a fund's investment objectives, - 3 - thereby requiring shareholder approval of any changes in those objectives. In addition, the Division proposes that the Commission eliminate the requirement that shareholders ratify the initial Rule 12b-1 plan of a newly organized fund.

**Distribution of Mutual Fund Shares**

**A. Section 22(d) - The Division** recommends that the Commission propose amending Section 22(d) of the Act to repeal the price maintenance requirement thereunder and replace it with authority for the Commission to issue orders or rules to limit the sale of redeemable securities at prices other than the prices set forth in a fund's prospectus.

**B. Other Distribution Financing Issues**

- In its Report, the Division suggests that the Commission should adopt (1) its outstanding rule (proposed Rule 6c-10) to permit deferred loads, including installment loads assessed directly on a shareholder's account, (2) limited amendments to Rule 12b-1 consistent with the continued use of spread loads and the proposal by the NASD to regulate these loads under its maximum sales load rule, and (3) a new exemptive rule to permit multiple class arrangements.

**Unified Fee Investment Companies**

The Division recommends that the Commission propose amending the Act to permit a new type of investment company -- a unified fee investment company ("UFIC"). A UFIC would have a single, fixed fee, set by its 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 the manager's own resources. Rule 12b-1 would not apply. Under this proposal, 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.

**Mutual Fund Advertising**

The Division recommends that the Commission propose amending the Securities Act to add a new provision for an "advertising prospectus" for mutual funds, the contents of which would not be restricted to information "the substance of which" is contained in the statutory prospectus. The Division's proposal also suggests rescinding the special provisions in the tombstone rule for mutual funds. In addition, the Division recommends that the Commission adopt amendments to Rule 482 of the Securities Act to permit mutual funds to sell shares directly from advertisements ("off-the-page"). Off-the-page advertisements would be required to - 4 - contain standardized, core information about the fund, such as - 5 - fees and expenses, performance data, investment objectives, and risks. The advertisements also would be required to inform investors about the availability of a statutory prospectus, and the fund still would 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 still be subject to prospectus liability under Section 12(2) of the Securities Act.

**Variable Insurance Products**

The Division recommends that the Commission propose legislation to amend Sections 26 and 27 of the Act to exempt variable insurance contracts from the specific charge limitations under those provisions. The amendment also would provide the Commission with rulemaking authority to establish standards of reasonableness for fees and charges if the market should fail to provide competitive prices or if abusive industry practices should develop. In connection with this proposal, the Division states that it will give priority to the development of a registration form for variable life insurance and standardized illustrations for variable insurance contracts.

**Repurchases and Redemptions of Investment Company Shares**

The Division recommends that the Commission adopt (1) a rule under Section 23 of the Act defining the circumstances under which closed-end funds may make periodic repurchase offers and (2) a rule under Section 22(e) permitting open-end funds to make redemptions on a periodic basis (e.g., monthly, quarterly) or with an extended period of payment (i.e., longer than seven days, as currently required). As part of these proposals, the Division recommends that the Act be amended to add an express requirement of portfolio liquidity for all open-end funds and for closed-end funds making periodic repurchases.

**Affiliated Transactions**

The Division recommends

limited changes to the rules governing affiliated transactions. Specifically, the Division recommends that the Commission propose changes to Rule 17d-1 to permit the directors, including the independent directors, to review and approve all joint transactions with remote affiliates and also to permit all joint transactions where the investment company and its affiliates participate on the same terms, except for the amount of the participation. In addition, the Division recommends amending 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 Division recommends that the Commission adopt a rule to - 6 - permit expedited treatment of exemptive applications where there - 7 - is available precedent. Under the proposed procedure, applicants generally would receive relief no later than 120 days after filing an application. In addition, the Division recommends that the Commission expand the Division's delegated authority to expedite review of applications. \* \* \* We will keep you informed of developments relating to the legislative and regulatory proposals recommended in the Division's Report. Craig S. Tyle Vice President - Securities Attachment

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