The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

MEMO# 14604

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DRAFT ICI REGULATORY REFORM PROPOSALS

[14604] April 8, 2002 TO: CLOSED-END INVESTMENT COMPANY COMMITTEE No. 14-02 SEC RULES COMMITTEE No. 29-02 RE: DRAFT ICI REGULATORY REFORM PROPOSALS In connection with plans to undertake a comprehensive review of the federal securities laws, SEC Chairman Harvey Pitt has invited the industry to make recommendations for possible regulatory changes. In response to this invitation, the Institute has prepared a draft package of regulatory reform proposals. The proposals include a number of recommendations that the Institute has previously submitted to the SEC as well as many new ones. The draft proposals are attached and are summarized below. Please review the attached proposals and provide any comments by the close of business on Friday, April 19th. You may provide your comments to Frances Stadler at 202/326- 5822 or frances@ici.org, or to Amy Lancellotta at 202/326-5824 or amy@ici.org. SUMMARY OF RECOMMENDATIONS I. RECOMMENDATIONS CONCERNING AFFILIATED TRANSACTIONS A. Permit Certain Affiliated Transactions Under Section 17. In 1998, the Institute submitted a series of proposed rules and rule amendments to the SEC designed to provide relief from prohibitions on affiliated transactions in circumstances where the prohibitions impede transactions that would benefit fund shareholders and that do not raise the concerns Section 17 was intended to address. The 1998 submission addressed the following areas: (1) mergers of certain affiliated investment companies; (2) transactions involving subadvisory affiliates; (3) in- kind redemptions by affiliated persons; (4) investment in an affiliated money market fund; (5) coincidental transactions; (6) riskless principal transactions; (7) transactions involving upstream affiliates; and (8) transactions involving affiliated portfolio companies. While noting progress on a few of these proposals, the draft submission strongly urges the Commission to take expeditious action on the Institute's 1998 proposals that remain pending. The draft submission also recommends that the Commission amend Rule 17d-1 to permit joint transactions by an investment company and its affiliates when the investment company participates on terms not different from those applicable to any affiliated participant, except for the amount of the participation, as suggested in the Division of Investment 2 Management's 1992 report, Protecting Investors: A Half Century of Investment Company Regulation ("1992 Study"). The Institute also included it in a 1995 submission to the Division of Investment Management that included a series of proposals to improve investment company regulation ("1995 Submission"). B. Amend the Rule on Cross-Transactions (Rule 17a-7). Rule 17a-7 under the Investment Company Act permits transactions between affiliated mutual funds subject to certain conditions. Among the requirements are specified methods for determining an independent market price. These methods do not appear to work for certain securities, such as Nasdaq securities. Because Nasdaq is a dealer market, use of the "last sale price" could benefit one fund and not the other. The draft submission recommends amendments to the rule to

address these problems. In reviewing this proposal, which was included in the 1995 Submission, please consider whether changes in the Nasdaq market since 1995 (e.g., the increase in commission-based trading and the narrowing of spreads) may reduce the need to amend the rule in this regard. C. Amend the Rule on Underwritings by Affiliates (Rule 10f-3). Rule 10f-3 provides a conditional exemption from the prohibition on fund purchases of underwritten securities when an affiliate is a member of the underwriting syndicate. One condition is that issuers of securities eligible for purchase under the rule must have been in continuous operation for at least three years. The draft submission recommends that the Commission eliminate this "unseasoned issuer" limitation because it inappropriately restricts fund investment choices and, given the other conditions in the rule, is not needed to protect investors. II. RECOMMENDATIONS CONCERNING SHAREHOLDER COMMUNICATIONS A. Improve Disclosure in Mutual Fund Shareholder Reports. The draft submission reiterates the Institute's previous recommendations to improve shareholder report disclosure by: (1) streamlining the schedule of investments by limiting disclosure to any holding that constitutes more than one percent of a fund's net assets and, at a minimum, the fund's top 50 holdings; (2) exempting money market funds from the requirement to disclose portfolio holdings; (3) requiring graphic presentations of portfolio information; and (4) requiring that the Management's Discussion of Fund Performance required by Item 5 of Form N-1A be included in a fund's annual report, whether or not it is also included in the fund's prospectus. The submission notes that we continue to strongly urge the Commission to reject suggestions to increase the frequency of fund portfolio holdings disclosure. B. Streamline Disclosure Regarding Independent Directors. The draft submission recommends that the Commission narrow the requirements to disclose certain positions, interests, transactions and relationships of independent directors and their immediate family members with funds and various related persons and entities that were adopted as part of the Commission's 2001 fund governance rule changes. The submission indicates that the current requirements impose unwarranted burdens on funds and their independent directors and, in many cases, would elicit disclosure of information that does not likely raise conflict of interest concerns. C. Permit Use of Profile to Support Additional Investments by Existing Fund Shareholders. The draft submission urges the Division of Investment Management to recommend that the Commission issue a proposal that would eliminate the need for funds to 3 deliver full, updated prospectuses to existing shareholders that make an additional investment in the same fund – by allowing funds to use a profile for this purpose. D. Eliminate the Form Used to Register Securities Issued in Business Combinations (Form N-14). The draft submission recommends that the Commission rescind Form N-14 and instead require delivery of the Form N-1A prospectus of the acquiring fund and a Schedule 14A proxy statement. It argues that this approach would provide investors with more useful disclosure and would be less burdensome and expensive to investment companies than the current disclosure regime. E. Amend the Requirement to Disclose the Source of Dividend Payments (Rule 19a-1). As suggested in the 1995 Submission, the draft submission recommends that the Commission replace the dividend source notification currently required under Rule 19a-1 under the Investment Company Act with a requirement that the source of dividend payments be identified in a fund's annual report to shareholders. III. RECOMMENDATIONS TO AMEND OTHER INVESTMENT COMPANY ACT RULES A. Amend the "Independent Legal Counsel" Provisions (Rule 0-1). The draft submission recommends that the Commission amend the new fund governance rules to address concerns that have arisen with the provisions relating to "independent legal counsel" that may be retained to represent independent fund directors. The Institute's proposed rule changes would, in essence, codify a recent SEC staff letter regarding these issues, thereby reducing potential litigation risk and providing greater certainty to independent directors and funds as to the funds' continuing ability to rely on certain key

exemptive rules under the Investment Company Act. B. Amend the Rule on Status of Certain Advisory Programs (Rule 3a-4). Rule 3a-4 under the Investment Company Act provides a nonexclusive safe harbor from the definition of “investment company” for certain investment advisory programs. Since the rule was adopted, various developments have called into question the extent to which investors in these programs are, in fact, receiving the individualized treatment that was deemed critical by the SEC when it adopted the rule. The draft submission recommends that the staff revisit Rule 3a-4 to determine whether conditions should be added to the rule or interpretive guidance should be issued to ensure that individualized investment advisory services are being provided by the programs relying on this safe harbor. One change that we recommend that the Commission consider is adding an express condition to the rule requiring that investment managers be required to make individualized suitability determinations for investors in these programs. C. Amend the Rule Governing Exchanges (Rule 11a-3). The draft submission recommends various changes to Rule 11a-3 to revise or eliminate conditions that are unduly restrictive and not necessary for the protection of investors or to achieve the purposes of Section 11 of the Investment Company Act. The proposed changes include: eliminating the requirement to provide 60 days’ prior notice to fund shareholders before an exchange offer can be terminated or materially amended; eliminating the requirement to include disclosure in advertisements and sales literature if a fund reserves the right to change the terms of, or 4 terminate, an exchange offer; and several technical changes concerning contingent deferred sales loads and installment loads. D. Amend the Rule Concerning Investments in Securities Related Businesses (Rule 12d3-1). The draft submission recommends that the Commission amend Rule 12d3-1 under the Investment Company Act to increase from five percent to ten percent the limit on the amount of an investment company’s assets that may be invested in a given issuer engaging in securities- related activities. It also recommends that the Commission codify relief granted to multi- managed funds under Section 12(d)(3) and Rule 12d3-1 where unaffiliated investment advisers advise discrete portions of such funds, and relief granted to exclude certain index funds from the restrictions of Section 12(d)(3). E. Amend the Fidelity Bonding Rule (Rule 17g-1). The draft submission reiterates the Institute’s recommendations for updating and improving Rule 17g-1 that were set forth in greater detail in a 1996 submission to the Commission. These recommendations include: establishing minimum coverage requirements for a fund complex rather than individual funds; setting a cap of $100 million on the amount of required fidelity bond coverage for a joint insured bond that names as insured members of the same fund complex; requiring that fidelity bonds be issued on an “each and every occurrence” basis; allowing all entities in a fund complex that are primarily engaged in providing investment management or investment advice to be named on the same joint bond; and simplifying and/or modernizing the current approval, filing, and notification requirements under the rule. F. Allow Interval Funds to Use Distribution Financing Arrangements (Rule 23c-3). Like our 1995 Submission, the draft submission recommends that the Commission permit interval funds to impose contingent deferred sales charges and/or asset-based sales charges, codifying exemptive relief it has granted to such funds. G. Eliminate Unnecessary Voting Requirements. The draft submission reiterates a recommendation from the 1995 Submission that the Commission eliminate the need for a shareholder vote where a fund wishes to (1) change a policy concerning “security based loans” (i.e., the use of repurchase agreements, the lending of portfolio securities, or the purchase of privately-offered debt securities), or (2) decrease its portfolio concentration in a particular industry or group of industries. IV. RECOMMENDATIONS CONCERNING VARIABLE INSURANCE PRODUCTS A. Amend Rules to Allow Mixed and Shared Funding. The draft submission recommends amendments to Rules 6e-2 and 6e-3(T) to eliminate the need for exemptive relief that allows open-end funds that underlie variable life insurance contracts

to offer their shares to separate accounts funding variable annuity contracts of the same or an affiliated insurer (“mixed funding”) or to separate accounts funding variable life insurance contracts or variable annuity contracts of unaffiliated insurers (“shared funding”). B. Adopt Rules to Allow Substitutions of Insurance Product Funds. The draft submission recommends that the Commission adopt a rule to permit insurance companies and their registered separate accounts to substitute shares of one underlying fund for another without the need to obtain exemptive relief from the Commission. A proposed companion rule 5 would permit in-kind transfers of portfolio securities from an existing underlying fund to a new underlying fund in effecting a substitution. V. OTHER REGULATORY RECOMMENDATIONS A. Revise the Staff’s Position Concerning the Liquidity of Section 4(2) Commercial Paper. The Commission and the staff have indicated that securities that are restricted as to resale, including commercial paper issued in reliance on Section 4(2) of the Securities Act, should be presumed to be illiquid for purposes of the 15% limit on fund investments in illiquid securities. In order to better reflect market reality and eliminate a meaningless fund board ritual, the draft submission recommends that the SEC staff issue interpretive guidance indicating that Section 4(2) commercial paper is presumptively liquid. B. Reduce the Frequency of Filing Reports on Form 13F. Section 13(f) of the Securities Exchange Act and Rule 13f-1 thereunder generally require institutional investment managers to file quarterly reports on Form 13F with the Commission if they exercise investment discretion over accounts holding more than $100 million in “13(f) securities.” In order to minimize potential abuses resulting from the availability of information contained in 13F reports, such as front running or free riding, the draft submission recommends that the Commission amend Rule 13f-1 to require semi-annual, rather than quarterly, reporting of the information and to increase the lag time for reporting from 45 days to 60 days after the end of the relevant period. C. Amend the Investment Adviser Advertising and Custody Rules. In 1998, the Institute submitted to the Division of Investment Management recommended revisions to update and modernize two rules under the Advisers Act: Rule 206(4)-1, which governs advertising practices; and Rule 206(4)-2, which governs custody or possession of customer funds or securities. The draft submission summarizes and reaffirms our 1998 recommendations. Frances M. Stadler Deputy Senior Counsel Attachment Attachment (in .pdf format)
