The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

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PROPOSED INVESTMENT COMPANY DEREGULATORY INITIATIVES

1 Please contact me if you have not received a copy of the Fields-Markey bill and would like to obtain one. April 12, 1995 TO: CLOSED-END FUND COMMITTEE No. 19-95 INVESTMENT ADVISERS COMMITTEE No. 19-95 SEC RULES COMMITTEE No. 55-95 UNIT INVESTMENT TRUST COMMITTEE No. 41-95 RE: PROPOSED INVESTMENT COMPANY DEREGULATORY INITIATIVES _____
As most of you are aware, House Telecommunications and Finance Subcommittee Chairman Fields and Ranking Minority Member Markey recently introduced legislation to amend the Investment Company Act, among other things, to "provide more effective and less burdensome regulation."1 In addition, the SEC has expressed interest in considering deregulatory initiatives that could be accomplished through the administrative process. Set forth below is a list of proposed deregulatory changes, along with other suggestions for improving investment company regulation, which, when finalized, we intend to provide to the SEC. (We recognize that some of the changes would need to be made by other agencies, and we will need to consider how to proceed with respect to those changes.) We would like your comments on the proposed regulatory changes set forth below and suggestions of any other changes that should be considered. In addition, please let us know if there are any statutory changes not included in the Fields-Markey bill that you would like the Institute to consider pursuing. Please provide the undersigned with your comments by Friday, April 28, 1995. My direct number is 202/326-5824. PROPOSED REGULATORY IMPROVEMENTS A. DEREGULATORY RECOMMENDATIONS 1. Adopt Summary Prospectus. In 1992, the SEC proposed the adoption of a rule that would permit mutual funds to use summary prospectuses. These would be short-form prospectuses that would contain SECmandated core information about the mutual fund in question. Investors who received a summary prospectus would be permitted to purchase shares, or could request a full prospectus for additional information. The summary prospectus would provide important information in a concise, easy-to-read format that would also facilitate the ability of investors to make comparisons among funds. The proposal should be adopted; if the SEC is unwilling to adopt it at this point for all funds, it should do so for money market funds and funds sold in the defined contribution retirement plan market. 2. Eliminate Certain Voting Requirements. There were two recommendations in the 1992 study concerning shareholder voting requirements that are not included in the Fields-Markey bill. These recommendations concern shareholder approval of "security-based loans" (defined in the study as repurchase agreements, the lending of portfolio securities and the purchase of privately-offered debt securities) and changes in an investment companyGs "concentration" policy. The SEC should take action to address these recommendations. 3. Rescind SIPC Disclosure Requirement for Confirmation Statements. Last November, the SEC amended Rule 10b-10 under the Exchange Act to require all brokers issuing confirmation statements that are not

members of SIPC to include disclosure to that effect on the confirmation statement. This requirement should be rescinded insofar as it applies to dedicated underwriters of mutual funds and unit investment trusts. These entities were exempted from SIPC by Congress in recognition of the fact that they are merely "conduit" entities and, thus, do not raise the risks that SIPC provides protection against. Consequently, the required disclosure will simply confuse investors by implying that their investments are subject to additional risk, when in fact the opposite is true. Implementation of the requirement also is very costly and burdensome from an operational standpoint. At the very least, relief should be granted under Rule 10b-10 to exempt mutual fund and unit investment trust underwriters from having to make non-SIPC status disclosure. 4. Amend Foreign Subcustodian Rule to Ease Burdens on Fund Directors. Rule 17f-5 under the Investment Company Act requires fund directors to make detailed findings concerning any foreign subcustodian utilized by a mutual fund. The 1992 SEC staff report on investment company regulation recommended revising the rule to reduce the burdens on fund directors, for example, by permitting them to delegate certain of their responsibilities under the rule. The Institute has submitted a proposal to the SEC to amend the rule in this manner, which is currently being considered by the Division of Investment Management. The SEC should adopt this proposal. 5. Streamline Disclosure of Securities Holdings in Semi-Annual and Annual Reports. Currently, funds are required to list separately each of their securities holdings in their semi-annual and annual reports. For large funds with extensive holdings, this list could be over 20 pages. Therefore, the list should be streamlined to provide shareholders with relevant information in a concise manner. One suggestion would be to allow funds with holdings of 100 or more securities at the end of the fiscal period to provide an abbreviated list of securities that would include the largest 50 security holdings by value, plus any security that comprised 1% or more of the value of the fundGs total investments if not already included in the largest 50 holdings. The abbreviated list of securities could be supplemented by additional information regarding the fundGs investments, as applicable: diversification by industry, by geography, and by type of security for equity funds; diversification by maturity (or duration) for bond and money market funds. In addition, the complete list of the fundGs investments prepared in accordance with the provisions of Regulation S-X would be filed with the SEC and would be made available upon request to any shareholder, without charge. 6. Amend Rule on Fund Cross-Transactions. 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 work for certain securities, such as NASDAQ equity securities and municipal bonds. The rule should be revised to address this problem. 7. Permit Certain Affiliated Transactions. a. Riskless Principal Transactions. Currently, investment companies are prohibited from engaging in riskless principal transactions with their affiliates. As a result, funds may pay higher execution costs for certain transactions, particularly for transactions in debt securities. Riskless principal transactions do not present the same possibilities for abuse found in classic principal transactions prohibited under Section 17 and should therefore be permitted by exemptive rule under that Section. 3b. “Bunching” Trades. Certain other affiliated transactions also should be permitted. The 1992 staff study recommended that Rule 17d-1 under the Investment Company Act be expanded to permit certain affiliated transactions (e.g., "bunching," in which a fund and its affiliate combine contemporaneous purchases or sales of securities of their various investment portfolios; joint repurchase agreements). These transactions do not present the risks that Section 17(d) was designed to prevent. Thus, this change would allow funds to engage in certain activities on a more cost-effective basis, without decreasing investor protection. c. “Upstream Affiliates”. An exemptive rule should be adopted under Section 17(a) to provide relief from the prohibition against a fund

in a complex doing principal business with a dealer that owns more than 5% of any fund within the complex, a so-called “upstream affiliate.” Trading with “upstream affiliates” does not present any significant potential for abuse. Not being able to trade with a major dealer, however, could be detrimental to fund shareholders, because funds may not be able to get best price or execution. In addition, trades that might be advisable for a fund could be prohibited. An exemptive rule to permit funds to deal with upstream affiliates could be modeled after Rule 17e-1, and require that the board, including a majority of the independent directors, (1) adopt procedures reasonably designed to ensure that such transactions are consistent with the standards of Section 17(a), and modify them as necessary, and (2) determine no less frequently than quarterly that any transactions with upstream affiliates were effected in compliance with such procedures. One condition of the rule could be that the fund in which the upstream affiliate is a 5% owner would be prohibited from doing business with that dealer. 8. Amend Rule on Underwritings by Affiliates. Rule 10f-3 under the Investment Company Act provides a limited exemption to the prohibition against a fund acquiring any securities from a member of an underwriting syndicate where any member of the syndicate is affiliated with the fund. The 1992 staff study recommended that Rule 10f-3 be expanded to permit funds to purchase foreign securities that are not currently exempt under the rule, which only exempts securities registered under the Securities Act and municipal securities. In addition, the percentage limitations currently in the rule limiting the amount of the offering that a fund may purchase and the amount of consideration it may pay are overly restrictive and should be increased. 9. Amend Interval Fund Rule. Rule 23c-3 under the Investment Company Act permitting closed-end funds to repurchase shares on a periodic basis does not permit such funds to impose contingent deferred sales loads (CDSLs) or asset-based sales charges (ABSCs). It has been suggested that it is because of this prohibition against the use of ABSCs that no interval funds have yet come to market. When Rule 23c-3 was adopted in 1993, the Commission stated that it would consider the appropriateness of the use of CDSLs and ABSCs by interval funds after it had adopted Rule 6c-10, permitting mutual funds to impose CDSLs, and had an opportunity to monitor the effects of the NASD's asset-based sales charge rule upon mutual fund distribution expenses. Rule 6c-10 was recently adopted and the Commission has now had adequate time to monitor the effects of the NASD rule. 10. Rules Applicable to UITs. Two changes should be made to rules under the Investment Company Act to decrease regulatory costs and burdens for unit investment trusts (UITs). First, a two- part registration statement for UITs should be adopted to permit the use of a Statement of Additional Information, a part of the registration statement that would not be required to be delivered with the prospectus but would be provided to investors upon request. Second, the filing fee requirements under the Investment Company Act should be amended to no longer require UITs to pay registration fees for 4sales of units in the secondary market. UITs should only be required to pay registration fees for units sold in the initial offering of a series because aggregate sales could never exceed aggregate purchases. 11. Proposed Legal Proceedings Disclosure. The Commission has proposed to require disclosure of certain past legal proceedings in investment company prospectuses and proxy statements. This requirement should not be adopted. There is no demonstrated need for this disclosure, which is directly contrary to the Commission's goal of simplifying fund prospectuses. Nevertheless, if this requirement is adopted, its scope should be narrowed significantly. 12. Proposed Custodian Account Statement Rule. The Commission has proposed a rule under the Investment Advisers Act to require an investment adviser to have a reasonable belief that custodian account statements are being delivered directly to the client. This rule should not be adopted, because (a) it would not prevent or deter the type of fraudulent conduct the Commission is attempting to remedy by this proposal, (b) it is not needed given other current regulatory requirements and (c) it is inappropriate for the

Commission to use investment adviser regulations to direct the activities of other persons over whom it does not have jurisdiction (i.e., bank custodians). 13. Repeal Ownership Restrictions for Passive Investors. Investment advisers and investment companies sometimes are limited in their investments in various regulated industries, because holdings over a certain threshold subject them to regulation under the applicable statute. Examples include ownership of public utilities under the Public Utility Holding Company Act and of communications firms under the Communications Act of 1934. There is little sense in imposing such restrictions in the case of passive investments not made for the purpose of exercising control. Regulatory action should be taken to exempt such investments from these requirements. 14. Hart-Scott-Rodino Filings. The Hart-Scott-Rodino Antitrust Improvements Act of 1976 requires that a premerger notification be filed in connection with the purchase by a single entity of a significant percentage of the outstanding voting securities of a registered investment company. The Federal Trade Commission has adopted a number of exemptive rules under the Act, including a rule exempting the acquisition of voting securities by certain institutional investors, as defined in the rule. The institutional investor exemption should be broadened. Under the current rule, the purchase of over $25 million of the shares of an investment company, where such amount equals over 15% of the fund's outstanding shares, would trigger the reporting obligations under the Act. The 15% threshold should be raised to 50%. 15. NYSE Annual Shareholder Meeting Requirement. The New York Stock Exchange rule requiring listed companies to hold annual meetings should be amended to exempt listed closed-end funds from this requirement. Closed-end funds incur significant costs in holding these meetings, which are not justified given that so few shareholders attend the meetings and that shareholders have alternative and more effective means for communicating with the fund in which they invest. In addition, closed-end funds are subject to detailed regulation under the Investment Company Act, which, among other things, requires a shareholder vote on certain specified matters. The Act, however, does not require that funds hold annual shareholder meetings and neither do the state laws under which most closed-end funds are organized. B. OTHER RECOMMENDATIONS 5 1. Fidelity Bond Rule. Rule 17j-1 under the Investment Company Act requires that officers and employees of investment companies with access to company assets be bonded against larceny and embezzlement by a reputable fidelity insurance company. The rule includes a schedule setting forth the minimum size of the bond required, based on the company's gross assets. Rule 17j-1, which was last amended in 1974, should be updated to reflect changes in the marketplace and the growth of the industry. Among other things, the rule should be amended so that the minimum amount of coverage required is based on aggregate assets under management rather than on each individual investment company's assets and to include a cap on the level of insurance required. Actual loss history shows that this approach would provide coverage that is more commensurate with the actual risk of loss. 2. Money Market Funds. In 1991, when the SEC adopted amendments to Rule 2a-7, the rule under the Investment Company Act governing money market funds, the requirements concerning the diversification and credit quality of portfolio securities were not extended to tax-exempt money market funds. Last December, the SEC proposed amendments to Rule 2a-7, among other things, to tighten the diversification and quality requirements applicable to tax-exempt money market funds. These amendments should be adopted promptly. The proposed diversification requirements would require national funds to meet the five percent diversification requirement currently applicable to taxable funds and would exempt single state tax-exempt funds from this requirement. The proposed credit quality requirement, which would prohibit single state funds from investing in "second tier" securities (as defined in the rule), should be modified to subject single state and national tax-exempt funds to the same credit quality limitations. Specifically, all tax-exempt funds should be subject to a five percent limit on fund

investments in second tier securities that are not traditional municipal obligations (i.e., "conduit securities", which is defined in the proposed amendments), and single state funds should be subject to a five percent issuer diversification requirement with respect to their investments in second tier traditional municipal obligations (i.e., non-conduit securities).
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