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January 4, 1991

INSTITUTE SUPPLEMENTAL MEMORANDA REGARDING REFORM OF REGULATION OF INVESTMENT COMPANIES

January 4, 1991 TO: BOARD OF GOVERNORS NO. 2-91 SEC RULES COMMITTEE NO. 3-91 1990s AD HOC COMMITTEE RE: INSTITUTE SUPPLEMENTAL MEMORANDA REGARDING REFORM OF REGULATION OF INVESTMENT COMPANIES ____ As you know, last October the Institute submitted an extensive comment letter on the SEC concept release regarding the reform of regulation of investment companies (See Institute Memorandum to Board of Governors No. 70-90, dated September 25, 1990 and Institute Memorandum to SEC Rules Members No. 70-90 and Members - One Per Complex No. 44-90, dated October 9, 1990). The attached four supplemental memoranda relating to the scope of coverage of the Investment Company Act of 1940 (the "1940 Act") were also filed with the Commission late last month. These memoranda provide additional background and detailed recommendations relating to three proposals included in the Institute’s October comment letter. 1) Repeal of the Exemptions in the Securities Laws for Bank Collective Funds Attachments A and B provide detailed background discussion and policy rationale in support of the Institute’s proposal to repeal the existing exemptions from the Securities Act of 1933 and the 1940 Act for bank collective funds sold to retirement plans. Attachment A notes that when Congress exempted these funds from the federal securities laws in 1970, banks were not permitted to advertise collective funds to the public, and the retirement plan market was dominated by defined benefit plans under which the employer exercised investment discretion and bore the full risk of the plan’s investment performance. However, since 1970, the ban on mass-marketing bank collective funds has been lifted, and the retirement plan market has undergone a dramatic change. Today, more and more employers are establishing defined contribution plans under which the employee bears the risk of poor investment performance. Further, an increasing number of such plans grant the individual employee the responsibility for selecting the investment vehicle for their - 1 - retirement plan from a range of investment options. Thus, banks are currently mass-merchandising their collective investment funds to thousands of employers and hundreds of thousands of individual employees, without the protections of the federal securities laws. Moreover, as noted in Attachment B, neither the Employee Retirement Income Security Act of 1974 (ERISA) nor the Comptroller of the Currency’s regulations applicable to bank collective funds provides an adequate substitute for the substantive protections of the 1933 and 1940 Acts. An exhibit to Attachment B compares the provisions of the 1933 and 1940 Act with the comparable provisions, if any, in ERISA and the Comptroller’s regulations. 2) Coverage of Asset-Backed Arrangements Attachment C sets forth in greater detail than the October comment letter the Institute’s proposal regarding the coverage of asset-backed arrangements under the 1940 Act. Specifically, the memorandum proposes bringing these arrangement within the scope of the Act as a new category of investment company, a structured securities pool ("SSP"). An SSP would be defined as an investment company that issues only non-redeemable securities and that holds only a fixed portfolio of income producing securities or receivables. Under the proposal, a new section of the 1940 Act, similar in many respects to current section 26 relating to unit investment trusts, would be created to govern the operations of an SSP. This provision would establish limits on permissible substitutions of assets and would impose standards on the servicer of an SSP. In addition, in light of the sensitivity of the securities being offered to changes in the market, the proposal establishes a procedure for the automatic effectiveness of an SSP's registration statement similar to that available for the series of a unit investment trust. 3) Private Investment Company Exemption A number of commenters on the SEC concept release suggested that the private investment company exemption in section 3(c)(1) of the 1940 Act be expanded to exclude "accredited investors", as defined under Regulation D of the 1933 Act, when calculating the number of persons owning the shares of the issuer. (Under section 3(c)(1), an issuer whose shares are owned by not more than 100 persons and who is not making a public offering is not an investment company.) Although the Institute's comment letter recommended that funds sold only to institutional investors, such as accredited investors, be exempted from certain provisions of the Act, these - 2 - funds would remain covered under the Act. Attachment D proposes an alternative approach to that suggested by the commenters, if - 3 - the Commission wishes to expand the section 3(c)(1) exemption. Specifically, the Institute's supplemental memorandum suggests that section 3(c)(1) be amended to exclude any issuer whose shares are held only by "qualified institutional buyers", as defined in Rule 144A, and which is not making or proposing to make a public offering. The exemption would be limited to funds with a minimum share denomination of $1 million. This proposal should allow various innovative and complex pooled investment vehicles to be offered to those most able to assess and bear the investment risk, while avoiding the burdens of compliance with the 1940 Act. * * * * * We will keep you informed of developments. Catherine L. Heron Deputy General Counsel