COMMENT LETTER

June 9, 1997

Comment Letter on Proposed Investment Company Name Rule, June 1997

June 9, 1997

Mr. Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

Re: Proposed Investment Company Name Rule
(File No. S7-11-97)

Dear Mr. Katz:

The Investment Company Institute[1] appreciates the opportunity to express its views on proposed Rule 35d-1 under the Investment Company Act of 1940. [2] The rule would require a registered investment company with a name suggesting that it focuses on a particular type of investment to invest at least 80% of its assets in the type of investment suggested by its name. In addition, the rule would specifically address names that suggest an investment company focuses its investments in a particular country or geographic region, names that indicate a company's distributions are exempt from income tax, and names that suggest a company or its shares are guaranteed or approved by the U.S. government.

We share the Commission's view that fund names should not be relied upon by investors as the sole or principal source of information about a fund's investments and risks.[3] Instead, investors should be encouraged to read a fund's relevant disclosure documents in deciding whether to invest in that fund. In this regard, the Commission has proposed two initiatives designed to improve mutual fund disclosure -- proposed revisions to Form N-1A and a new rule under the Securities Act of 1933 and the Investment Company Act to permit an investor to buy a fund's shares based on a fund "profile."[4] The Institute strongly supports those initiatives, which would enhance the ability of investors to understand the risk and reward characteristics of a particular fund.[5]

Nevertheless, we recognize that the name of a fund may communicate important information to investors and may be a useful screening tool to help an investor identify an appropriate fund for specific investment goals. Therefore, it is appropriate that a fund

whose name indicates that it will invest in a particular security or industry does, in fact, follow an overall investment strategy consistent with its name. We have supported existing standards designed to achieve such consistency, and we generally support the Commission's proposed new standards.[6] Our support, however, is conditioned upon the proposal being revised in three important respects. First, funds should not be required to adopt the investment requirement as a fundamental policy. Second, the standard should apply only "under normal conditions" to provide funds with appropriate portfolio management flexibility. Third, the "net assets plus borrowings" standard should apply to only those funds that have adopted a policy to borrow for investment purposes; all other funds should be required to use only a "net assets" standard.

These suggested changes are designed to advance the objectives of the rule while ensuring that funds required to implement the proposed 80% investment requirement are able to manage their portfolios effectively in the interests of their shareholders. The requirements of Rule 35d-1 should not be so stringent as to discourage funds from using descriptive names. A descriptive name may help investors identify funds that would best serve their investment objectives. Descriptive names are particularly helpful in differentiating funds within a family of funds.

The Institute appreciates that this proposal raises a number of difficult and complex issues that warrant careful and thoughtful consideration. As a result, it may take the staff considerable time to resolve all of those issues. This should not, however, delay the Commission in moving forward on the proposed revisions to Form N-1A and the proposed fund profile rule. While all three proposals are designed to achieve the same goal of promoting effective communication about funds to investors, there is no reason why they need to proceed on the same timetable. In fact, it would be in the best interests of investors to move forward promptly with the adoption of the other proposals, rather than to delay such proposals in the event that the name rule is not ready for adoption at the same time.

The Institute's suggested revisions to proposed Rule 35d-1, along with additional comments that we have on the proposal, are discussed below.

I. Fundamental Policy Requirement

Proposed Rule 35d-1 would require the 80% investment requirement to be a fundamental policy of the fund (i.e., a policy that may not be changed without shareholder approval). As a rationale for this requirement, the Release states, "[T]he requirement to adopt the 80% investment requirement as a fundamental policy would prevent a company from changing its name and its investment emphasis without the consent of shareholders." Currently, only funds with names suggesting that their distributions are tax-exempt are required to adopt fundamental policies with respect to their investment strategies. Thus, this would be a new requirement for most funds subject to Rule 35d-1.

The Institute strongly opposes requiring any fund, including tax-exempt funds, to adopt the 80% investment requirement as a fundamental policy. Making the 80% investment requirement a fundamental policy is unnecessary from a shareholder protection standpoint. At the same time, it could significantly restrict the ability of funds to respond efficiently to market events or to new regulatory requirements, to the detriment of investors. In fact, it might even undermine the effectiveness of the proposed rule, as it could discourage funds from adopting names that would be subject to Rule 35d-1.

As an initial matter, we note that funds (other than tax-exempt funds or funds with

concentration policies) currently are not required to seek shareholder consent before changing their investment objectives or changing their names.7 We are not aware of any problems or concerns that have occurred as a result of this, nor are any mentioned in the Commission's Release.8 In the absence of any such problems, we question the need to make the 80% requirement a fundamental policy.

At the same time, the proposal would constrain the ability of funds to change their investment strategies if they view such a change to be in the best interests of their shareholders.9 In this regard, the proposed fundamental policy requirement would transform Rule 35d-1 from a "truth-in-labeling" disclosure rule into a substantive rule governing portfolio management and corporate governance. As a consequence, the requirement might deter some funds from adopting a descriptive name that otherwise would do so.

Based on the foregoing, the Institute strongly opposes the proposed requirement that funds adopt the 80% investment requirement as a fundamental policy.10

II. Application of the 80% Test

The proposed 80% investment requirement would apply at the time a fund invests its assets. The Institute generally supports this approach, which would allow a fund to continue to hold a portfolio security that met the 80% standard at the time of purchase but may no longer do so as a result of changed circumstances. For instance, a small company fund that purchased the securities of a small, growing company that has since grown into a large, highly capitalized company would be permitted to continue to hold that security (rather than be forced to sell it in order to comply with the 80% investment standard).

As proposed, the rule would codify current staff positions and provide an exception to the 80% investment requirement in the case of "temporary defensive" investments made in order to avoid losses in response to anticipated adverse market, economic, political, or other conditions. While it is important that an exception for "temporary defensive" investments be provided under the rule, we do not believe that this exception alone is broad enough to provide funds with sufficient flexibility to manage their portfolios in a manner consistent with the best interests of their shareholders. Therefore, the Institute recommends that the Commission revise the rule to require that the name test apply only "under normal conditions," as it currently does.

The industry for many years has complied with the existing name test subject to an "under normal conditions" standard. There is no explanation provided in the Release for eliminating the "under normal conditions" standard and replacing it with a narrower "temporary defensive" exception. This change would unduly restrict appropriate investment management practices. For instance, there may be conditions under which it is in the best interests of shareholders for a fund to maintain an unusually large cash position, such as pending the availability of appropriate investments (e.g., in the event of heavy cash flows into the fund) or in anticipation of a high level of redemption requests. Unless the Commission explicitly permits funds to engage in such practices under the proposed rule, funds may be faced with the Hobson's choice of making what they believe to be inappropriate investments or leaving fund assets uninvested (rather than investing in appropriate short-term obligations). Neither course of action would advance the Commission's objectives or serve the interests of a fund's shareholders.

The adoption of an "under normal conditions" standard may be especially important in the

case of new funds, particularly those investing in emerging markets or industry sectors. These funds may not be able to meet an 80% test immediately upon commencing operations because of a limited supply of appropriate securities.11

In the release adopting the rule, the Commission should provide examples of when it would be appropriate for a fund to deviate from the 80% standard due to the absence of normal conditions. Such examples would provide helpful guidance to the industry in complying with an "under normal conditions" standard. At the very least, funds should be permitted to deviate from the 80% test to make "temporary defensive" investments and to hold cash, cash equivalents or short-term instruments pending the availability of appropriate investments in the event of heavy cash flows into the fund,12 or in anticipation of a high level of redemption requests.13 Conversely, to protect against potential abuses under this standard, the Commission should include examples of when it would not be appropriate to deviate from the 80% investment restriction. For instance, it would not be appropriate for a stock fund to invest primarily in Treasury notes for an extended period of time under market conditions similar to those existing today.14

Any fund that reserves the right to deviate from the 80% standard in the absence of normal conditions should be required to disclose this fact in its prospectus, describe generally the circumstances under which it may do so and indicate that it may hold cash, cash equivalents and/or certain short-term obligations during that time.15 We do not believe that any additional disclosure in this regard should be required.16 Instead, a more detailed "after the fact" discussion of the impact that such a position may have had on a fund's performance should be required in the management's discussion of the fund's performance.17

III. Net Assets Plus Certain Borrowings

The proposed 80% investment requirement would be based on a fund's net assets plus any borrowings that are senior securities under Section 18 of the Investment Company Act.18 The Institute recommends that only those funds that have adopted investment policies that allow them to borrow for investment purposes (and not just for temporary or emergency purposes) be required to base the test on net assets plus borrowings, and that only the borrowings used for those purposes be included.19 In all other instances, the requirement should be based only on a fund's net assets.

The suggested approach is entirely consistent with the stated purpose of this requirement -- "to prevent a company from circumventing the 80% investment requirement by investing borrowed funds in securities that are not consistent with the company's name."20 At the same time, it would avoid producing certain unintended consequences, such as requiring a fund to include "borrowings" undertaken pursuant to standard overdraft arrangements, and would ease compliance burdens under the rule.

IV. The 80% Test: General

The Institute requests that the Commission clarify two general issues arising under the proposed 80% name test.

First, with respect to the types of securities that would qualify towards meeting the 80% standard, the Commission should clarify that a fund may invest in synthetic instruments, such as options, swaps, forwards and futures, that have economic characteristics similar to

the underlying securities. For instance, a stock fund should be permitted to buy stock index futures contracts. We understand that the staff permits this type of investment for purposes of the current name test. Investing in synthetic securities often allows a fund's adviser to find the cheapest source of value for shareholders, which is one of the central reasons why investors invest in funds in the first place. Moreover, permitting funds to invest in these instruments will, in many instances, increase the supply of securities available to fund advisers. Thus, it is particularly important that funds be permitted to invest in these types of synthetic instruments if the investment requirement is increased to 80%. Of course, a fund that intends to purchase such instruments would be required to disclose this fact in discussing its investment objectives and strategies in its prospectus.

Second, the Commission should clarify that a fund may use any reasonable definition of the terms used in its name, and that the terms should be defined in the fund's prospectus in the discussion of its investment objectives and strategies. Allowing funds to define terms used in their names would help to ensure that the 80% standard does not unnecessarily restrict investment management flexibility.21 This clarification appears to be consistent with the Commission's intent, as evidenced by note 39 of the Release, and the staff's current positions.

V. Specific Types of Funds

The Institute has several comments on the proposals regarding specific types of funds (i.e., "government" funds, funds with names focusing on particular countries or geographic regions and "tax-exempt" funds), which are set forth below.22

A. Funds with Names that Include "Treasury" or "Government"

Under proposed Rule 35d-1, a fund that includes the words "Treasury" or "government" in its name would be required to invest, as applicable, at least 80% of its assets in U.S. Treasury securities or U.S. government securities.23 In connection with this requirement, the Commission has solicited comment on whether restrictions should be adopted with regard to the types of Treasury or government securities that a fund with a name indicating an investment emphasis in such securities should be allowed to purchase. The Commission noted in the Release, for instance, that a fund with the word "government" in its name could invest in many types of government securities with very different risk characteristics (e.g., direct Treasury obligations, Government National Mortgage Association collateralized mortgage obligations). The Release suggests that such restrictions may be useful to protect against investor confusion about the "safety" of a government fund.

The Institute would oppose amending the proposed rule to restrict the types of government securities that such funds may purchase. Imposing substantive portfolio restrictions of this kind is beyond the stated objective of the rule, i.e., to protect against the use of misleading names. Use of the terms "government" and "Treasury" in a fund's name indicate the fund's principal investment strategy. The fact that there are different types of government securities (with different risk characteristics) is irrelevant for this purpose, so long as at least 80% of a fund's net assets are invested in "government" securities. In addition, the rule should not be used as a vehicle to regulate fund risks. A fund with the word "government" in its name only communicates to investors information regarding the credit risk of its portfolio securities. It is not intended to convey information about any of the other risks (e.g., interest rate risk) of the fund.24 Imposing portfolio restrictions to reduce interest rate risk would inappropriately transform Rule 35d-1 into a substantive rule governing a fund's portfolio investments, similar to Rule 2a-7. Moreover, restricting the types of

securities that a government fund could purchase to reduce interest rate risk would alter drastically the fundamental nature of these funds.

Restricting the types of government securities also may act as a deterrent against funds using "government" or "Treasury" in their names, which would be detrimental to investors inasmuch as inclusion of those terms in a fund's name can be a useful screening tool. The Commission's concerns about investor confusion regarding the "safety" of a government fund would be better addressed by improving a fund's disclosure documents to provide clear and comprehensible information about a fund's risks. The Commission's proposed revisions to Form N-1A and the proposed fund profile should go a long way in accomplishing that objective. Moreover, if such a fund holds itself out as having a stated maturity policy, adopting a requirement that it have a commensurate duration policy, as discussed below in Section 7, would also address the Commission's concerns in this area.

B. Names Focusing on Countries or Geographic Regions

The Commission has proposed a two-part test for funds with names that suggest that they focus their investments in a particular country or in a particular geographic region.25 The Commission solicited comment on this approach generally, and in particular whether the three specific criteria alone should be used or, alternatively, whether only the general requirement (the first prong of the test) should be imposed.

The Institute recommends that only the general requirement (without the fundamental policy requirement) be imposed, and that the three specific criteria be adopted as alternative "safe harbors" for determining compliance with the requirement. The general requirement would be sufficient to protect against the use of misleading names.26 Using both prongs of the test would create an unnecessarily stringent standard. There does not appear to be any compelling reason to subject this category of funds to a standard that would be much more stringent than that imposed on other types of funds. In addition, there may be instances where an investment, such as a foreign stock index futures contract traded on a U.S. commodities exchange, would fail to meet all three criteria,27 yet would expose a fund to the same economic benefits and risks of the country or geographic region indicated in its name. The three specific criteria, however, each appear to be appropriate standards in most instances for funds to employ, even though they may not be the only reasonable standards. Therefore, we recommend that the specific criteria be adopted as alternative safe harbors for purposes of determining compliance with the general standard.

C. Tax-exempt Funds

Proposed Rule 35d-1 would require a fund that uses a name suggesting that its distributions are exempt from federal income tax or from both federal and state income taxes to have a fundamental policy:

(i) to invest at least 80% of its assets in securities the income of which is exempt, as applicable, from federal income tax or from both federal and state income tax; or

(ii) to invest its assets so that at least 80% of the income that it distributes will be exempt, as applicable, from federal income tax (under both the regular and alternative minimum tax rules) or from both federal and state income tax.

While we generally support this requirement, the Commission should revise it in two important respects. First, as stated above, we do not believe that a fund should be required to adopt any investment strategy under the proposed rule as a fundamental policy. Therefore, this requirement should be deleted from paragraph (a)(4) of the proposed rule

for the reasons discussed above in Section 1.

Second, single state money market funds that are subject to Rule 2a-7 under the Investment Company Act should be exempt from proposed Rule 35d-1. In several states, the supply of tax-free instruments that are eligible for purchase by money market funds is severely limited (either at all times or sporadically during the year in connection with seasonal patterns of note issuance). As a result, some of these funds may not be able to meet the proposed 80% test. Indeed, in recognition of the limited supply of such instruments, the Commission has proposed to relax the definition of "single state fund" in Rule 2a-7.28 This flexibility permits a fund to be managed in a fashion that seeks to maximize the extent to which its shareholders receive income exempt from state or local taxes, while at the same time observing the quality, maturity and diversification requirements under Rule 2a-7, which significantly limit the investment options available to a money market fund. Imposing a strict percentage test on such funds would be inconsistent with the proposed amendments to Rule 2a-7. In addition, it might force some single state money market funds to change their names. Limiting the ability of such funds to use appropriately descriptive names would hamper investors' ability to identify investments appropriate for their financial and tax needs.

In addition to the changes recommended above, the Commission should clarify that under the proposed 80% requirement, a single state tax-exempt fund would be permitted to treat as a qualifying asset a security that pays interest exempt from both federal and state taxation but that is not issued by an issuer located in that state.29 Securities of issuers located in certain territories of the United States are exempt from federal and state taxation.30 The ability of a fund to deem such securities as qualifying assets for purposes of the proposed requirement is particularly important for those single state funds in states where the supply of appropriate securities is limited. In addition, investors in single state tax-exempt funds typically are concerned with the tax-free nature of distributions to them as taxpayers in a given state, as distinct from the geographic location of the issuers in which the fund invests. Any fund that invests in securities issued by tax-exempt issuers located outside the state in question should be required to disclose this fact in its prospectus.

Finally, we request that the staff reconsider its position that municipal obligations generating income subject to taxation under alternative minimum tax (AMT) rules may not be counted as tax-exempt obligations for purposes of the 80% test. The Institute had made a similar request in 1987, which the staff denied at that time.31 The staff's position was based in large part on its view that the use of the term "tax-exempt" in a fund's name would be misleading if some of the shareholders would receive income subject to the AMT, even if the fund's prospectus clearly discloses this fact. We disagree. The only fund shareholders who would be subject to the AMT would likely be financially sophisticated and, therefore, aware that they might be subject to the AMT, even though the name of the fund includes the term "tax-exempt." Moreover, the number of shareholders subject to the AMT appears to be very low.32 The staff's position, however, may be a disservice to the overwhelming number of fund investors who are not subject to the AMT inasmuch as it may deter funds from including "tax-exempt" in their names.

VI. Enforcement of Proposed Rule 35d-1

The Institute urges the Commission and its staff to enforce proposed Rule 35d-1 in a flexible and thoughtful manner, to take into consideration, among other things, that the

rule is new and that it does not, nor should it, address every conceivable interpretative issue that may arise thereunder. The latter is particularly relevant given that the marketplace and investment practices are continuously changing. Moreover, there might be different ways, all of which are appropriate, for funds to comply with various aspects of the rule. Finally, and perhaps most significantly, the rule should not be enforced in a manner that would inappropriately create or impose a "strict liability" standard on funds.

The Commission's consistent focus should be on whether a fund is engaged in misleading conduct of a sort that Rule 35d-1 seeks to address, and not whether the fund in some technical sense is "out of compliance" with the 80% standard. For instance, a fund complex may bunch purchase orders of different funds. Because it may take some time to execute such an order, the individual funds would not know specifically when their orders will be executed. As a result of changing market conditions or cash flows into or out of a fund, an order for a non-qualifying asset may be executed on a day when the fund has fallen below the 80% threshold (although the fund was over the 80% threshold on the day the order was placed). A similar issue may arise in the context of limit orders. Funds should not be precluded from engaging in these types of trading practices, which are customary in the industry and in the best interests of shareholders. These are just two examples of why it is so important that the rule be enforced in a deliberate, common-sense manner.

VII. Average Weighted Portfolio Maturity and Duration

The Release reports that the Division of Investment Management no longer intends to require funds with names indicating a specified maturity policy (e.g., "short-term," "long-term") to have average weighted portfolio maturities of specified lengths. The Division is of the view that a reasonable investor would not necessarily expect that funds with such names would in fact be subject to specified maturity limits. In addition, the Division does not believe that the maturity of a fund's portfolio securities accurately reflects the sensitivity of the fund's share price to changes in interest rates. Instead, the Release notes that duration, which reflects the sensitivity of a fund's returns to changes in interest rates, may be a more accurate measure of a fund's interest rate volatility. In this regard, the Commission requests comment on whether the maturity of a fund's portfolio suggested by the fund's name should be consistent with its portfolio duration and, if so, on an appropriate method or methods for calculating duration.

The Institute strongly supports requiring a fund that holds itself out as having a stated maturity to have a commensurate duration policy. As we stated in our comment letter on the Commission's concept release on improving mutual fund risk disclosure, "This requirement would help to ensure that funds are managed in a manner consistent with investor expectations about the funds' sensitivities to interest rate risk."[33] In order to implement such a requirement, it will be necessary to develop a standardized methodology for calculating average portfolio duration. We previously submitted preliminary recommendations of the Institute's Duration Task Force relating to a standardized methodology for calculating portfolio duration, to assist the staff in developing such a methodology. The Task Force is continuing to work on those recommendations. We hope to submit final recommendations to the staff in the near future. Until such a methodology is adopted, however, we do not believe that the Commission should impose any limitations on the portfolio duration of a fund with a stated maturity policy.[34]

The Institute does not agree with the staff's decision to no longer impose specified maturity limits on a fund that has a stated maturity policy in it name. We believe that this issue

requires further consideration insofar as there may be instances in which maturity may be more appropriate than other interest-rate sensitivity measures, such as duration. In this regard, the Institute offers its assistance to the staff in evaluating the utility of specified maturity limits. Moreover, until the Commission is ready to adopt alternative limitations, it is premature to no longer require compliance with the current maturity limits. Accordingly, we recommend that the staff reverse its decision to no longer impose maturity limits on a fund that has a stated maturity policy in its name.

VIII. Effective Date

The Commission has proposed a one year transition period before funds must begin complying with proposed Rule 35d-1. We do not believe that one year is sufficient given the portfolio adjustments and changes to internal compliance systems that may be necessary and the need for those funds that do not wish to be subject to the rule to change their names. Instead, assuming the Commission proceeds with this proposal at the same time as it moves forward with the proposed amendments to Form N-1A,35 it should adopt a consistent transition period.36 This is important inasmuch as funds may need to revise their prospectus disclosure as a result of the adoption of Rule 35d-1. Different effective dates would impose unjustified costs and burdens.37

* * *

The Institute appreciates the opportunity to comment on this significant rule proposal. If you have any questions regarding our comments above, please contact the undersigned at 202/326-5810, Craig Tyle at 202/326-5815 or Amy Lancellotta at 202/326-5824.

Sincerely,

Paul Schott Stevens
Senior Vice President
General Counsel

cc: The Honorable Arthur Levitt, Chairman
The Honorable Steven M.H. Wallman, Commissioner
The Honorable Isaac C. Hunt, Jr., Commissioner
The Honorable Norman S. Johnson, Commissioner
Barry P. Barbash, Director, Division of Investment Management

ENDNOTES

1 The Investment Company Institute is the national association of the American investment company industry. Its membership includes 6,456 open-end investment companies ("mutual funds"), 440 closed-end investment companies, and 10 sponsors of unit investment trusts. Its mutual fund members have assets of about $3,677 trillion, accounting for approximately 95% of total industry assets, and have over 59 million individual shareholders.

2 SEC Release No. IC-22530 (Feb. 27, 1997) (the "Release").

3 Release at 5.

4 SEC Release No. IC-22528 (Feb. 27, 1997) and SEC Release No. IC-22529 (Feb. 27, 1997),

respectively.

5 See Letters from Paul Schott Stevens, Senior Vice President and General Counsel, Investment Company Institute, to Jonathan G. Katz, Secretary, Securities and Exchange Commission (June 9, 1997) (regarding proposed revisions to Form N-1A (S7-10-97) and the proposed fund profile (S7-18-96)).

6 The Institute notes that the proposal would impose a more restrictive investment requirement than is currently imposed by the Commission staff under Guide 1 to Form N-1A. We do not believe, nor does it appear to be the Commission's view, that funds relying on the 65% standard in Guide 1 have engaged in misleading conduct. To avoid any inference to the contrary, we request that the Commission clearly state in the release adopting Rule 35d-1 that the higher standard does not mean that current practices that comply with Guide 1 were inappropriate.

7 State corporate and business trust laws in the jurisdictions in which the vast majority of mutual funds are organized (i.e., Maryland, Massachusetts and Delaware) do not require shareholder approval to change a fund's name.

8 Early versions of the securities reform legislation enacted last year would have required each fund's investment objective to be a fundamental policy. This provision was dropped from the legislation at an early stage. The Commission should not attempt to impose additional requirements under Section 13 of the Investment Company Act in the absence of Congressional authority.

9 The burdens associated with obtaining shareholder approval are compounded by the high threshold that must be satisfied in obtaining a vote of a majority of the outstanding voting securities under Section 2(a)(42) of the Investment Company Act. Many funds have a difficult time obtaining enough responses to even obtain a quorum.

10 We further note that such a requirement would raise a technical issue with respect to unit investment trusts (UITs). Because UITs do not typically issue voting stock, they could not be required to adopt the investment restriction as a fundamental policy.

11 The Commission's Release expressly solicited comment on whether certain funds may require more flexibility than others in meeting the new requirement. Release at 16-17. With respect to new funds, the Commission should provide guidance in the adopting release or provide an express safe harbor in the rule consistent with the approach taken in Guide 1 to Form N-2. Guide 1 permits new funds generally to take up to six months to invest net proceeds. Funds investing in a single foreign country or region or in small businesses (as defined in the guide) may take up to two years, provided that appropriate disclosures are made. In addition to new funds, closed-end funds that conduct periodic tender offers or that periodically repurchase their shares pursuant to Rule 23c-3 under the Investment Company Act may need to hold substantial cash or cash equivalents at certain times in order to meet shareholder tenders or repurchase requests.

12 We note that an international fund may, pending investment of its assets, hold short-term obligations denominated in currencies of the countries in which it intends to focus its investments, to maintain the necessary currency exposure and to facilitate an efficient purchase of portfolio securities denominated in that currency.

13 If the Commission is not inclined to adopt an "under normal conditions" standard, we

urge that the rule be revised to include an explicit exception for these types of cash management practices, as well as for temporary defensive positions.

14 See, e.g., In the Matter of Eric S. Emory and Renaissance Advisers, Inc., Admin. Proc. File No. 3-7530; Release No. IC-18245 (July 22, 1991) (revoking the registration of a closed-end fund and imposing remedial sanctions on the president of the fund's adviser based on, among other things, a material misrepresentation in the fund's prospectus stating that the fund's investment objective was to achieve capital appreciation by exclusively investing in particular equity securities when, in fact, the fund for four years had invested solely in treasury bills and cash or cash equivalents).

15 Of course, a fund could continue to hold non-qualifying assets in its 20% basket during that time.

16 Under the proposed amendments to Form N-1A, a fund would be required to disclose "the percentage of its assets that may be committed to temporary defensive positions (e.g., up to 100% of the fund's assets), the risks, if any, associated with the positions, and the likely effect of these positions on the fund's performance." See supra note 4. The Institute does not believe that this disclosure should be required because (1) most, if not all, funds would indicate that up to 100% of their assets may be committed to such positions, to maintain maximum flexibility, and (2) it would be impossible to predict the effect such positions would have on a fund's performance, or to put this information in the proper perspective inasmuch as the circumstances under which a fund might take such a position could vary dramatically and the circumstances themselves might have a significant impact on the fund's performance. See Letter from Paul Schott Stevens to Jonathan G. Katz (regarding proposed revisions to Form N-1A), supra note 5.

17 The MDFP can be included in a fund's prospectus or annual report. See Item 5A of current Form N-1A.

18 In explaining the rationale for basing the test on a fund's net assets rather than total assets as currently required, the Release states that certain transactions may increase a fund's total assets because total assets do not reflect certain liabilities. As an example, note 31 of the Release describes the accounting treatment for when a fund loans its portfolio securities. Specifically, note 31 states that "when a company lends its securities, total assets would include a receivable for the security loaned..." Many funds, however, do not record a receivable, but rather include the securities on loan in the schedule of investments and indicate in the footnotes to the fund's financial statements the aggregate value of the portfolio securities loaned and the value of the securities received as collateral. This accounting treatment is consistent with Statement of Financial Accounting Standards No. 125, which treats securities lending transactions of the type that funds typically engage in as financing transactions and not sales. See paragraph 64 of FAS No. 125. We request that this point be clarified in the release adopting the rule to avoid any confusion that note 31 might create.

19 Under our proposal, all borrowings used for investment purposes would be included, regardless of whether they are senior securities under Section 18 of the Investment Company Act.

20 Release at 15.

21 It is particularly important for certain funds, such as sector funds, that include terms for

which there are not commonly accepted definitions to have the discretion to define the terms used in their names. This approach would allow, for instance, a "Paper Fund" to invest not only in companies whose business activities are directly related to the paper industry, but also other companies (e.g., publishing and printing companies) whose success may affect the demand for and, thus, the price of paper products.

22 In addition, there is an issue regarding certain types of funds addressed in the Release on which we seek clarification. Specifically, the discussion in Section II.C. implies that certain fund names not specifically addressed in the rule, such as "small, mid, or large cap" funds, are "not covered" and, thus, not subject to the 80% investment requirement. Release at 18-19. We request that the Commission clarify this issue to avoid any future confusion. On a related matter, we are pleased that the staff intends to provide advice on a case-by-case basis to funds with names not covered under the proposed rule.

23 The staff previously has prohibited funds from treating certain stripped U.S. government securities issued by private special purpose trusts (e.g., CATS and TIGRS) as government securities because they are not directly issued by the U.S. government. We respectfully request that the staff reconsider that position inasmuch as those instruments are issued by pass-through entities and, as such, are analytically identical to repurchase agreements fully collateralized by U.S. government securities, which the Commission treats as U.S. government securities in other contexts (e.g., under Rule 2a-7).

24 Paragraph (a)(1) of the proposed rule would prohibit a fund from using a name that suggests that the fund or its shares are guaranteed or approved by the U.S. government or any U.S. government agency or instrumentality. The Institute supports this aspect of the proposal.

25 The proposed test is as follows:

first, such funds would be required to have a fundamental policy to invest at least 80% of their assets in securities of issuers that are tied economically to the particular country or region indicated by their names; and second, such funds would be required to invest in securities that meet any of the following criteria:

(i) securities of issuers that are organized under the laws of the country or a country within a geographic region suggested by the fund’s name or that maintain their principal place of business in that country or region;

(ii) securities that are traded principally in the country or region suggested by the fund’s name; or

(iii) securities of issuers that, during the issuer’s most recent fiscal year, derived at least 50% of their revenues or profits from goods produced or sold, investments made, or services performed in the country or region suggested by the fund’s name or that have at least 50% of their assets in that country or region.

26 Funds should disclose in their prospectuses the criteria that they use to select their portfolio securities in meeting the general standard.

27 In addition to being traded in the U.S., such a contract would be issued by a U.S. entity that generates all of its income in the U.S., thereby failing all three criteria.

28 Specifically, the Commission has proposed to permit a tax-exempt fund to qualify as a

single state fund under Rule 2a-7 if it "holds itself out as seeking to maximize the amount of its distributed income that is exempt from the income taxes or other taxes on investments of a particular state." SEC Release No. IC-22383 (Dec. 10, 1996) (emphasis added). In amendments to Rule 2a-7 adopted by the Commission in March 1996, "single state fund" had been defined as a tax-exempt fund that "holds itself out as primarily distributing income exempt from the income taxes of a specified state or locality." SEC Release No. IC-21837 (March 28, 1996) (emphasis added).

29 This clarification is still required even if single state money market funds are exempt from the rule. If those funds are not exempted from the rule, the need for this clarification will be even greater.

30 For instance, an Ohio tax-free fund may wish to purchase securities of an issuer located in Puerto Rico.

31 Letter from Mary Joan Hoene, Deputy Director, Division of Investment Management, Securities and Exchange Commission, to Matthew P. Fink, Senior Vice President and General Counsel, Investment Company Institute (Nov. 3, 1987).

32 While we do not have data on the number of shareholders subject to the AMT, we note that the number of taxpayers subject to the tax is minimal. For example, only 0.29% and 0.32% of all individual tax returns reported AMT liability in 1993 and 1994, respectively. See Internal Revenue Service Statistics of Income Bulletin, Winter 1996-97.

33 Letter from Paul Schott Stevens, General Counsel, Investment Company Institute, to Jonathan G. Katz, Secretary, Securities and Exchange Commission (July 28, 1995) (File No. S7-10-95).

34 A fund that currently has a stated duration policy, as opposed to a stated maturity policy, should be permitted to calculate duration in any manner it deems appropriate until a standardized methodology is developed. Such a fund should be required to maintain records of the methodology it uses and make the records available to Commission examiners during an inspection of the fund.

35 As noted above, however, we strongly urge the Commission not to delay adoption of the proposed amendments to Form N-1A or of the profile pending resolution of all of the outstanding issues under this proposal.

36 Specifically, the transition period should be at least eighteen months from the effective date of the proposal in the case of existing funds. See Letter from Paul Schott Stevens to Jonathan G. Katz (regarding proposed amendments to Form N-1A), supra note 5.

37 The Institute requests that existing UITs whose assets are fully invested prior to the adoption of the rule be "grandfathered." Because of the fixed nature of UIT portfolios, such UITs would not be able to adjust their portfolios to comply with the rule, and requiring that they change their names would impose undue administrative costs and burdens with no corresponding investor benefits (particularly given that many existing UITs are no longer even being offered in the secondary market).

abridged and therefore incomplete. Communications from the Institute do not constitute, and should not be considered a substitute for, legal advice.