COMMENT LETTER

February 23, 2001

Comment Letter on SEC Securities Underwritings Proposal, February 2001

February 14, 2001

Mr. Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 5th Street, N.W.
Washington, D.C. 20549-0609

Re: Exemption for the Acquisition of Securities During the Existence of an Underwriting or Selling Syndicate
(File No. S7-20-00)

Dear Mr. Katz:

The Investment Company Institute[1] is pleased to provide comments on the Securities and Exchange Commission's proposed amendments to Rule 10f-3 under the Investment Company Act of 1940, the rule that permits a registered investment company ("fund") that has certain affiliations with an underwriting participant to purchase securities during an offering.[2] The Commission's proposal would expand the exemption provided by the rule to permit a fund to purchase government securities in a syndicated offering. The proposal also would modify the rule's quantitative limit on purchases to cover not only purchases by a fund and any other funds with the same investment adviser, but also purchases by any other account over which the fund's investment adviser has discretionary authority or exercises control.

The Institute supports the Commission's proposal to extend Rule 10f-3 to government securities sold in syndicated offerings. By allowing funds to purchase securities in these offerings, this proposed change would help ensure that the rule does not unduly restrict funds' investment opportunities. With the same goal in mind, we recommend that the Commission take the following additional actions. First, we propose that the Commission increase from 25 percent to 50 percent the rule's current limit on purchases by a fund and any other funds advised by the same adviser. (We do not support, however, the proposed application of the rule's quantitative limit to purchases by an adviser's non-fund accounts.) Second, we recommend that the Commission adopt, with certain modifications, a previous proposal to allow purchases of municipal securities in "group sales" under the rule. Third, we reiterate our recommendation that the Commission adopt a new rule to address situations where a "technical" affiliation results in the application of Rule 10f-3's restrictions

to certain subadvised funds, notwithstanding the absence of any potential conflict of interest.

Our comments are discussed in greater detail below.

A. Purchase of Government Securities

The Commission's proposal would expand the scope of the rule to permit a fund to purchase government securities during the existence of an underwriting or selling syndicate in which an affiliated underwriter is a participant. The Institute supports this proposed change. As explained in the Proposing Release, various government sponsored enterprises recently have begun to offer their securities through syndicated offerings.3 Funds with affiliated underwriters should not be denied the opportunity to purchase securities in those offerings if appropriate investor protections are in place.

The Proposing Release requests comment on whether the rule should include limitations on the purchase of government securities that do not apply to other securities purchased under the rule. We do not believe any such limitations are necessary. As the Proposing Release points out, government securities are high-quality instruments that are readily marketable, and thus, unlikely to be "dumped" into a fund.4 We also agree that the circumstances under which government agencies offer their securities to the public would be an effective substitute for registration under the Securities Act of 1933 for purposes of Rule

10f-3.5 The nature, quality, and marketability of government securities, when combined with the other restrictions of Rule 10f-3, provide adequate safeguards to protect against the potential abuses that the rule is intended to address.

B. Percentage Limit

Rule 10f-3 limits the securities purchased by a fund, or by any other funds having the same investment adviser, to 25 percent of the principal amount of the offering of the class of securities.6 The Institute has two comments relating to the percentage limit.

1. Level of Limit

In 1996, the Commission proposed to liberalize the limits on the amount of an offering that funds with the same investment adviser may purchase under Rule 10f-3.7 The Institute recommended that the Commission eliminate these quantitative limits for most types of offerings, because the other conditions of Rule 10f-3 are sufficient to provide assurances of the marketability of the securities being offered. 8 The Institute suggested that if the Commission determined that a percentage limit remained necessary, that limit should be 50 percent of the total principal amount of the offering.9

The Institute continues to believe that the current 25 percent limit imposed by the rule is more restrictive than necessary for the protection of investors and does not provide sufficient flexibility to funds to achieve their investment objectives given the growth of the fund industry and the increasing number of funds with affiliated underwriter relationships.10 When this threshold was adopted, the Commission expressed the view that a percentage limit was necessary to ensure that a significant portion of an offering would be purchased by persons other than the fund complex that is affiliated with the underwriter. 11 A 50 percent threshold also would meet this objective and, when combined with the

other conditions of Rule 10f-3, would provide sufficient protection against potential "dumping" of securities, without placing undue restrictions on funds. Accordingly, we urge the Commission to increase the current threshold to 50 percent of the principal amount of the offering in order to provide funds greater flexibility to purchase securities when their affiliated underwriters are members of underwriting syndicates.

2. Purchases Covered by the Limit

As previously noted, in applying the percentage limit in Rule 10f-3, the Commission's proposal would require the aggregation of purchases not only by two or more funds having the same investment adviser, but also by any other account over which the adviser has discretionary authority or exercises control. The Proposing Release states that this modification would close a possible "loophole" in the rule that could permit an investment adviser to circumvent the percentage limit and compromise the effectiveness of the rule by purchasing most or all of an offering for its non-fund clients while complying with the limit for its fund clients.12 The Institute opposes this proposed change for the reasons set forth below.

First, the Commission has not adequately demonstrated a need for this amendment. The Proposing Release fails to provide any factual predicate for expanding the scope of the rule's restrictions in this way. It points to no example where the conduct that this proposal seeks to address has occurred, much less where fund shareholders have been harmed as a result.

Second, the Institute is concerned that requiring an adviser to include purchases by non-fund accounts when applying the percentage limit could potentially harm fund shareholders by unduly restricting their investment opportunities (e.g., by limiting fund purchases of securities subject to Rule 10f-3 to a much smaller amount than would be permitted but for purchases by the adviser's non-fund accounts). Aggregating purchases by non-fund accounts with those of funds advised by an adviser could have a similar adverse impact on the non-fund accounts. In some instances, the impact of the proposed requirement could be that the adviser will forego investing in the securities altogether, because the amount that each fund or account could purchase might be too small to have any significant effect on any individual fund or non-fund account. Given that the other conditions of Rule 10f-3 already minimize the possibility that securities covered by the rule would be dumped into a fund's portfolio, thus achieving the rule's purpose, the proposed aggregation requirement has the potential to do more harm than good.

The Proposing Release requests comment on whether the current 25 percent quantitative limit should be increased in light of the proposed aggregation requirement. As discussed above, the Institute believes that the limit should be increased without regard to this proposal. If the Commission decides to adopt the aggregation requirement despite our objections, the need for an increase in the percentage limit becomes even more acute.13

C. Group Sales

When Rule 10f-3 was last amended, the Commission had considered permitting the purchase of municipal securities in "group sales."14 The Commission proposed revising the rule to cover such sales in certain circumstances.15 That proposal was never adopted, however.

The Institute urges the Commission to amend its present proposal to permit funds to

purchase municipal securities in group sales. Increasing demand for municipal securities has shown that the need for rulemaking relief still exists. We recommend that the Commission amend the rule to allow affiliated funds not only to place group orders (pursuant to which the affiliated underwriter would receive credit for its pro rata share of the order) but also to place "designated orders" (i.e., orders in which the purchaser specifies which underwriter(s) will receive credit for the order) naming the affiliated underwriter. In addition, the rule could be amended to provide that, in the case of a designated order, the affiliated underwriter may not receive a commission on more than its underwriting share of the order (i.e., the same amount it would receive on a group order). The economic result of these changes would be the same for funds and their affiliated underwriters whether group orders or designated orders are used, thus giving funds wider access to municipal securities offerings than is presently the case.16

D. Transactions Involving Subadvisers

Our final recommendation deals with another way in which Rule 10f-3 is unnecessarily restrictive. It involves the application of the rule to certain purchases of securities solely on the basis of a technical affiliation, as discussed below.

As a technical matter, a fund with a subadviser may be subject to the prohibition of Section 10(f) (and, thus, the conditions of Rule 10f-3) if an affiliated fund has a different subadviser that is affiliated with an underwriter in a syndicate. The same can be true in the case of a multi-managed fund (i.e., a fund with several unaffiliated subadvisers that are each assigned to make investment decisions for discrete portions of the fund's portfolio) where one subadviser wishes to purchase securities in an underwriting and a member of the syndicate is affiliated with a different subadviser.17

As the Institute has previously asserted, the abuses Section 10(f) was designed to prevent are not present in the context of the subadvisory relationships described above.18 A subadviser to one fund has no direct or indirect power or authority to furnish advice or make investment decisions with respect to a fund it does not advise. Thus, a decision by a subadviser to purchase securities from an underwriting syndicate, a principal underwriter of which is an affiliated person of a subadviser to a different fund, involves no potential for dumping unmarketable securities. The same is true in the case of a multi-managed fund. In that circumstance, no individual subadviser to the fund is in a position to furnish advice, make investment decisions, or otherwise influence those portions of the fund that it is not contractually assigned.

Application of Rule 10f-3's restrictions in the foregoing circumstances serves no investor protection purpose and may act as an impediment to otherwise desirable transactions. A staff no-action position and numerous Commission exemptive orders have recognized that these transactions present little danger of self-dealing or overreaching, and provide the Commission with an adequate basis for codifying this relief.19 This rule proposal presents an obvious opportunity for the Commission to address these issues by adopting a new rule under Section 10(f) to clarify that these transactions are not subject to the prohibitions under that section of the Act.20

* * *

The Institute appreciates the opportunity to comment on the Commission's proposed amendments to Rule 10f-3. If you have any questions about our comments or would like additional information, please call the undersigned at (202) 326-5923.

Sincerely,

Barry E. Simmons
Associate Counsel

Attachment

cc: Paul F. Roye
Director

C. Hunter Jones
Assistant Director

Curtis A. Young
Senior Counsel

ATTACHMENT
Rule 10f – Underwriting Transactions
Involving Certain Subadvisory Affiliates

(a) A purchase or other acquisition of securities by a registered investment company from an underwriting or selling syndicate that includes as a member the subadviser (or an affiliated person of such subadviser) of a different registered investment company under common control with that registered investment company, shall be deemed not to be prohibited by Section 10(f), if:

1) no principal underwriter of the underwriting or selling syndicate is an affiliated person of: (A) the subadviser or investment adviser of the registered investment company participating in the transaction, or (B) any officer, trustee, director, or employee of the registered investment company participating in the transaction; and

2) the subadviser (or affiliated person of such subadviser) that is a member of the underwriting or selling syndicate is an affiliated person of an affiliated person of the registered investment company that is a party to the transaction solely because it serves as subadviser to a different registered investment company under common control with the registered investment company that is a party to the transaction.

(b) For purposes of this rule:

1) The term "subadviser" shall mean an investment adviser as defined in section 2(a)(20) of the Act who, pursuant to a contract with the primary investment adviser of a registered investment company, renders: (A) investment advice with respect to some or all of the cash and investment securities of such investment company and/or (B) related services.

2) The term "registered investment company" shall include any series thereof, and shall include any discrete portion of such registered investment company or series that is advised by a subadviser that is different from the subadviser or subadvisers who render service to the remaining assets of such registered investment company or series.

ENDNOTES

1 The Investment Company Institute is the national association of the American investment company industry. Its membership includes 8,414 open-end investment companies

("mutual funds"), 489 closed-end investment companies and 8 sponsors of unit investment trusts. Its mutual fund members have assets of about $6.937 trillion, accounting for approximately 95% of total industry assets, and over 83.5 million individual shareholders. Many of the Institute's investment adviser members render investment advice to both investment companies and other clients. In addition, the Institute's membership includes 381 associate members which render investment management services exclusively to non-investment company clients. A substantial portion of the total assets managed by registered investment advisers are managed by these Institute members and associate members.

2 SEC Release No. IC-24775 (November 29, 2000); 65 Fed. Reg. 76189 (December 6, 2000) ("Proposing Release").

3 See Proposing Release at 76190.

4 Id.

5 Id. In particular, the Proposing Release notes that: (1) government agencies generally must obtain approval from the Department of Treasury concerning the timing, price, and terms of the securities offering; (2) information about government securities typically is publicly available through prospectuses or similar offering documents; and (3) government securities trade actively in the secondary market.

6 In the case of Rule 144A securities, the 25 percent limit applies to the total of the principal amount of the offering of the class of the securities sold by underwriters or members of the selling syndicate to "qualified institutional buyers," as defined in Rule 144A, plus the principal amount of the offering of such class in any concurrent public offering.

7 See SEC Release No. IC-21838 (March 21, 1996). The proposal would have increased these limits from the greater of 4% of the principal amount of the offering or $500,000, but in no event more then 10% of the principal amount of the offering, to 10%, $1,000,000 and 15%, respectively.

8 See Letter from Craig S. Tyle, Vice President & Senior Counsel, Securities and Financial Regulation, Investment Company Institute, to Jonathan G. Katz, Secretary, Securities and Exchange Commission, dated June 10, 1996. The Institute recommended that a quantitative limit continue to apply in the case of certain non-public foreign securities offerings, foreign Rule 144A securities offerings where there is no concurrent foreign public offering, and domestic Rule 144A securities offerings.

9 Id.

10 Consolidations in the financial services industry, for example, have increased the number of underwriter affiliations.

11 See SEC Release No. IC-22775 (July 31, 1997) (adopting amendments to Rule 10f-3).

12 See Proposing Release at 76191.

13 We further note that the Commission’s aggregation proposal would exacerbate the issue discussed below in Section D of this letter concerning subadvisers who must comply with Rule 10f-3’s restrictions because of technical affiliations that do not raise conflict of interest

concerns.

14 A "group sale" is a sale of municipal securities resulting from a "group order," which is an order for securities for the accounts of all members of a syndicate in proportion to their respective participations in the syndicate.

15 The Commission had proposed to permit group sales provided that: (1) such purchases could be made only where the syndicate has established that orders designated as group orders will have first priority or that only group orders will be filled; and (2) that at the time of a group sale, the affiliated underwriter may not be obligated to underwrite more than 50 percent of the principal amount of the offered securities.

16 We suggest that the Commission continue to process exemptive orders in this area while it considers possible rule amendments to accommodate group sales.

17 The definition of "investment adviser" in Section 2(a)(20) of the Investment Company Act includes a subadviser. In addition, each subadviser to a fund is an investment adviser to the entire fund, not just the portion of the fund it manages. Section 2(a)(3) of the Act defines an "affiliated person" of another person to include, among other persons, any person directly or indirectly controlling, controlled by, or under common control with such other person and, if such person is an investment company, any investment adviser thereof. As an affiliate of each fund that it advises, a subadviser is a second-tier affiliate of any fund under common control with the fund it advises, including any fund that is advised by a different, unaffiliated subadviser (i.e., a "non-advised fund").

18 See Letter from Craig S. Tyle, General Counsel, Investment Company Institute, to Paul F. Roye, Director, Division of Investment Management, Securities and Exchange Commission, dated December 10, 1998 (transmitting the Institute’s comprehensive recommendations for new and amended rules regarding affiliated transactions).

19 See North American Security Trust and NASL Series Trust (pub. avail. Feb. 2, 1993) (permitting a fund to purchase securities during the existence of an underwriting syndicate in which an affiliated person of the subadviser of another fund was participating as a principal underwriter). The Commission also has issued several exemptive orders that permit a multi-managed fund to purchase securities in offerings underwritten by a principal underwriter that is a direct or indirect affiliate of such fund solely because of the underwriter’s subadvisory relationship with a different portion of assets of that same fund. See, e.g., Frank Russell Investment Company, SEC Rel. No. IC-24847 (Jan. 30, 2001); AMR Investment Services Trust, SEC Rel. No. IC-23823 (May 4, 1999); Morgan Stanley, Dean Witter, Discover & Co., SEC Rel. No. IC-23422 (Sept. 1, 1998); SunAmerica Asset Management Corp., SEC Rel. No. IC-23161 (Apr. 29, 1998); and Goldman, Sachs & Co., SEC Rel. No. IC-22887 (Nov. 13, 1997).

20 For your convenience, we are attaching to this letter a copy of the proposed rule language we previously submitted for this purpose. As we previously recommended, similar rules also should be adopted under Sections 17(a) and 17(e) of the Act.