The Asset Management Industry
SERVING INDIVIDUAL INVESTORS

INVESTMENT COMPANY INSTITUTE

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Second Letter Recommending Improvements to Industry Regulation, May 2002

Proposals to Improve Investment Company Regulation

May 1, 2002

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I. Recommendations Concerning Affiliated Transactions

A. Permit Certain Affiliated Transactions Under Section 17

1. 1998 ICI Recommendations

One of the cornerstones of the Investment Company Act of 1940 is Section 17, which prohibits certain transactions involving investment companies and their affiliates in order to ensure that investment companies are managed in the best interests of their shareholders, rather than for the benefit of affiliated entities. Section 17 undeniably has served shareholders well and, by bolstering the investing public's confidence in the investment company industry, also has contributed to the industry's success. While its restrictions remain fundamentally sound, there is an increasing number of instances in which they impede transactions that would benefit fund shareholders and that do not raise the concerns the section was intended to address.

With this in mind, the Institute in 1998 submitted to the Division of Investment Management a series of proposed rules and rule amendments designed to provide relief from prohibitions on affiliated transactions in these circumstances, while maintaining appropriate safeguards to protect the interests of fund shareholders. [1] There has been progress on some these proposals [2] but, unfortunately, most of them have yet to be considered by the Commission. We continue to strongly urge the Commission to take expeditious action on our 1998 proposals that remain pending. [3]

2. Joint Transactions on an Equal Basis (Rule 17d-1)

In its 1992 study of investment company regulation, the Division recommended amendments to Rule 17d-1 to permit certain types of 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. [4] The Division expressed the view that, in many cases, these transactions do not present the risks that Section 17(d) was designed to prevent—the participation by an investment company on a basis different from or less advantageous than that of any other participant—and may provide substantial benefits to shareholders. We agree with the Division's recommendation and urge that Rule 17d-1 be amended to permit investment companies to engage in such transactions, without having to seek individual exemptive relief. [5] The language we recommend is consistent with the Division's general recommendation in the 1992 Study, [6] although the 1992 Study did not provide specific language. The Institute's recommended language would require the investment company board to adopt procedures reasonably designed to ensure that the transactions comply with the requirements of the rule. [7]

Our recommended rule language is set forth below.

Proposed Amendments to Rule 17d-1 to Permit Certain Joint Transactions
New language in bold

Amend paragraph (d), to read as follows:

"(d) Notwithstanding the requirements of paragraph (a) above, no application need be filed pursuant to this rule with respect to any of the following:

* * *

"(9) A transaction to which a registered investment company (or one or more series of a registered investment company) and an affiliated person of such company, or an affiliated person of such a person, are parties ('participants'); provided that:

"(A) The terms of the proposed transaction are reasonable and fair and do not cause any investment company (or series of an investment company) to participate on a basis that is less advantageous than that of any other participant (except with respect to the amount of participation);

"(B) The board of directors of each registered investment company, with respect to the investment company (or series of such investment company) concerned, including a majority of the directors who are not interested persons of such investment company:

"(1) determines that participating in such transactions is in the best interests of the investment company (or series) and its

shareholders;
"(2) adopts procedures that are reasonably designed to ensure that the transactions meet the requirements set forth in paragraph (A) above; and
"(3) determines no less frequently than quarterly that all transactions effected during the preceding quarter pursuant to this rule complied with such procedures;

"(C) The investment company (1) shall maintain and preserve in an easily accessible place a written copy of the procedures (and any modification thereto) described in paragraph (B)(2) above, and (2) shall maintain and preserve for a period not less than six years from the end of the fiscal year in which any transactions occurred, the first two years in an easily accessible place, a written record of each such transaction setting forth its terms, the identity of the parties to the transaction, and the information or materials upon which the assurances described in paragraph (B)(3) were based; and

"(D)(1) A majority of the directors of the investment company are not interested person of the company, and those directors select and nominate any other disinterested directors of the company; and

"(2) Any person who acts as legal counsel for the disinterested directors, other than a person who provides services as a special counsel, [8] is an independent legal counsel."

B. Amend the Rule on Underwritings by Affiliates (Rule 10f-3)

Section 10(f) of the Investment Company Act prohibits a fund from knowingly purchasing or otherwise acquiring, during the existence of any underwriting or selling syndicate, any security a principal underwriter of which is an investment adviser of the fund or an affiliate of that adviser. Congress adopted Section 10(f) in response to concerns about investment bankers "dumping" otherwise unmarketable securities into portfolios of investment companies, by unduly encouraging or causing the investment company to purchase unmarketable securities either from the underwriting affiliate itself, or from another member of the syndicate.

Rule 10f-3 exempts from Section 10(f) a fund's purchase of underwritten securities subject to certain limitations, including the so-called "unseasoned issuer" limitation. This limitation requires that the issuer of securities eligible for purchase under the rule (other than municipal securities) "shall have been in continuous operation for not less than three years, including the operation of any predecessors." [9] For the reasons discussed below, the Institute recommends that the Commission amend Rule 10f-3 to eliminate the unseasoned issuer limitation.

The unseasoned issuer limitation unnecessarily constrains the professional judgment of portfolio managers of funds affiliated with underwriters. A fund that is precluded from purchasing securities of an unseasoned issuer in an initial public offering as a result of its affiliation with a principal underwriter must wait until the syndicate has closed and then purchase the securities in the aftermarket. This waiting period may result in the fund paying a significantly higher price for the securities. In addition, funds may pay additional transaction costs, such as brokerage commissions, when purchasing securities in the secondary market, costs that they do not pay when purchasing directly in an underwritten offering. While the length of time of an issuer's continuous operations may be an appropriate factor for consideration, it should not be the basis for a regulatory limitation that precludes a fund manager from exercising investment judgment.

The unseasoned issuer limitation is based on the assumption that IPOs of unseasoned issuers are so highly speculative so as to be relatively unmarketable. While this may have been true when Rule 10f-3 was adopted in 1958, the market no longer expects companies seeking to go public to have three years of operations. In recent years, IPOs by issuers with less than three years of operations not only have become commonplace, but also highly marketable. Indeed, at times the demand for such IPOs by investors, including institutional investors, has far outstripped the supply and has caused the aftermarket price for those securities to substantially exceed the IPO price. In such situations, the unseasoned issuer limitation has served not to protect fund investors but to deprive them of attractive investment opportunities.

The unseasoned issuer limitation is particularly anomalous for fund investments in certain asset-backed securities (ABSs). ABSs tend to be relatively safe investments with high ratings from ratings agencies and they typically offer returns that are higher than those of U.S. Treasury securities with comparable maturities. [10] Because of these characteristics, they are attractive investments for many funds. Unfortunately, the legal structure of ABSs implicates the letter, but not the spirit, of the unseasoned issuer limitation. When assets such as debt obligations are securitized, the assets are held by a newly created special purpose entity (SPE). The SPE, not its sponsor, also issues the ABSs themselves. Investors that desire to acquire ABSs generally must purchase them in the primary offering, since there is generally not a significant secondary market for ABSs. However, because SPEs have less than three years of continuous operations at the time of the primary offering, the unseasoned issuer limitation precludes funds from purchasing in that offering when an affiliate is a principal underwriter of the offer. The unfortunate result is that these funds face severe limitations on investing in ABSs.

The adverse impact of the unseasoned issuer limitation has been aggravated by the consolidation of the financial services industry.

Consolidation among financial services firms has made it more likely that a fund-affiliated underwriter will be a member of the underwriting syndicate.

Not only does the unseasoned issuer limitation inappropriately restrict fund investment choices, but also it is not needed to protect investors. The other conditions of the rule provide adequate protection against potential “dumping” abuses. [11] Moreover, removal of the unseasoned issuer limitation would be consistent with the Commission’s longstanding recognition since the adoption of Rule 10f-3 that the rule can serve its intended purpose only if it is periodically adapted to changing conditions in the financial markets and regulatory environment. [12] Accordingly, the Institute recommends that the Commission eliminate the unseasoned issuer limitation in Rule 10f-3. [13]

II. Recommendations Concerning Shareholder Communication

A. Improve Disclosure in Mutual Fund Shareholder Reports

The Division of Investment Management has been developing a rulemaking proposal designed to improve disclosure in mutual fund shareholder reports. The Institute strongly supports the goals of making shareholder reports more comprehensible, informative and useful to the average investor. As we recommended in an earlier submission to the Division on this topic, as part of this initiative, [14] the Commission should make changes to improve disclosure of mutual fund portfolio holdings in those reports. Under the current requirements, funds must disclose every investment, which can lead to a very lengthy list that generally is not helpful to most investors. For funds with a large number of holdings, such as index funds, current requirements greatly increase the length and complexity of shareholder reports (thus increasing the printing and mailing costs, which are passed on to shareholders).

We therefore suggest that the Commission eliminate the requirement to disclose all fund holdings. Instead, the Commission should require disclosure of any holding that constitutes more than one percent of a fund’s net assets and, at a minimum, the fund’s top 50 holdings. [15] We also recommend that money market funds be exempt from the requirement to list portfolio holdings, given the strict regulation of money market funds’ portfolios under Rule 2a-7 under the Investment Company Act and the short-term nature of such portfolio holdings. [16] To address any concerns that the Commission or a fund’s shareholders would not receive complete information regarding fund holdings, the Commission could require a complete list of holdings as of the last day of the reporting period to be filed with the Commission and provided to shareholders at no charge upon request.

The Institute also continues to support changes to require graphic presentations of portfolio information, such as pie charts showing different categories of securities held in a fund’s portfolio. Many funds already provide this type of disclosure because it facilitates investor understanding of a fund’s portfolio holdings. A requirement that all funds provide graphic presentations would benefit investors by making it more broadly available. We recommend that funds retain the flexibility to determine what type of chart, table, or graph would provide the most useful information to shareholders given the fund’s investment objectives and limitations.

In addition, as we previously suggested, the Commission should consider 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 MDFP fits naturally with other “backward looking” information about a fund’s performance, such as the fund’s financial statements.

B. Streamline Disclosure Regarding Independent Directors

In January 2001, the Commission adopted a number of rule and form amendments related to investment company governance.[17] The changes were designed to enhance the independence and effectiveness of fund directors and to provide investors with greater information about fund directors. Among the changes are requirements for director-related disclosure beyond that previously required in fund statements of additional information and proxy statements. All new fund registration statements, post-effective amendments that are annual updates to registration statements, proxy statements for the election of directors and shareholder reports filed with the Commission on or after January 31, 2002 must comply with the new disclosure requirements.

As fund groups have begun to implement the new disclosure requirements, it has become evident that some of the requirements create unwarranted burdens on funds and their independent directors. In particular, the requirements to disclose positions, interests, transactions and relationships of independent directors and their immediate family members with the fund and various related persons and entities are very broad in scope. The sweeping breadth of these requirements not only makes them burdensome but, more importantly, in many cases would elicit disclosure of information that is not indicative of a potential conflict of interest.

The requirements cover certain positions with: (1) the fund; (2) any investment company (including private investment companies) that has the same investment adviser or principal underwriter as the fund or that has an investment adviser or principal underwriter that directly or indirectly controls, is controlled by, or is under common control with an investment adviser or principal underwriter of the fund; (3) an investment adviser, principal underwriter, or affiliated person of the fund; or (4) a person directly or indirectly controlling, controlled by, or under common control (control person) with an investment adviser or principal underwriter of the fund. [18]

They also cover certain interests of independent directors or their immediate family members in transactions in which any of (1) through (4) above, or an officer of (1) through (4) above, was a party, and certain relationships with any of such persons or entities. [19] In addition, they cover certain interests in an investment adviser or principal underwriter of the fund or a control person of a fund adviser or underwriter. [20] Finally, they cover instances where an officer of an investment adviser or principal underwriter of the fund or of a control person of the adviser or underwriter has served during the two most recently completed calendar years on the board of directors of a company of which an independent director or his or her immediate family member is an officer. These requirements result, in some instances, in the identification of an enormous universe of persons and entities, particularly where the fund's investment adviser is part of a large conglomerate and/or the fund uses subadvisers (especially where the subadvisers are part of large conglomerates). Independent directors then must review a very lengthy list of persons and entities for purposes of determining whether disclosure is required.

In response to comments indicating that the disclosure requirements as originally proposed were overly broad, the Commission narrowed some of the requirements when it adopted the final amendments. For example, the Commission's proposal would have covered positions, interests, transactions or relationships with the fund's administrator or any entity that controls, is controlled by, or is under common control with, the administrator. The final amendments did not include administrators, except to the extent that an administrator controls, is controlled by, or is under common control with the fund's investment adviser or principal underwriter. The Institute recommends further changes to eliminate some potential disclosure of situations that likely would not raise conflict of interest concerns and to mitigate excessive burdens on independent directors and funds. [21]

First, we reiterate our previous recommendation that the scope of covered positions, interests, transactions and relationships be limited to those that involve a fund's investment adviser, principal underwriter, or their parents or subsidiaries, and thus not include all entities under common control with the adviser or principal underwriter. [22] As we indicated previously, information concerning entities under common control with the adviser or underwriter would be of limited value to assessing a fund director's independence, because the attenuated nature of the relationship between a sister company of the adviser or underwriter and the fund makes any conflict of interest unlikely.

Second, we recommend that the Commission revise the disclosure requirements to exclude positions, interests, transactions or relationships with subadvisers (other than any subadviser that controls or is controlled by the fund's primary investment adviser or principal underwriter). Although an independent director's relationship with a subadviser potentially could raise conflict of interest concerns, these concerns are moderated to a significant degree by the involvement of the fund's primary adviser in negotiating subadvisory arrangements. Furthermore, the burdens of identifying all of the persons and entities that potentially could trigger a disclosure requirement, and having independent directors review an extensive list of such persons and entities, far outweigh any benefit that such disclosure might provide. Fund groups generally must rely on each subadviser to provide them with the information and to do so on a timely basis. Fund groups also have no way to verify the accuracy or completeness of the information they receive.

C. Amend After-Tax Return Disclosure Rules

In January 2001, the Commission adopted rules to require mutual funds to disclose standardized after-tax returns.[23] This disclosure is intended to enhance fund shareholders' understanding of the impact that taxes can have on fund performance and permit investors to compare the impact of taxes on the performance of different funds. The rules as adopted, however, include features that seriously undermine their ability to assist investors. The problems with the rules are as follows:

- Under the rules, after-tax returns are required to be computed by applying the highest marginal income tax rate, notwithstanding the fact that this rate is applicable to no more than a de minimis portion of fund shareholders. As a result, the vast majority of fund shareholders will receive disclosure that has little relevance to them and that will greatly overstate the tax consequences of investing in mutual funds.
- The rules compound the problem noted above by applying the short-term capital gains rate to the one-year total return number. While, as a technical matter, short-term rates apply for investments held exactly one year, it is highly unlikely that any shareholders would redeem on such date, when the shareholder would be eligible for long-term treatment if he or she held the shares for one additional day. Consequently, the rules further distort the tax implications of mutual fund investing.
- The rules mandate that after-tax return numbers be included in the "risk/return summary" section of fund prospectuses, rather than in the section on tax disclosure. This makes it difficult for funds to place the disclosure in proper context, as well as to fully explain important aspects of it, including the fact that it employs an assumed tax rate that may differ from the shareholder's, and that it is not applicable to shares held in tax-deferred accounts.

These concerns need to be addressed; overstating the impact of the tax consequences of investing in mutual funds and limiting the ability of funds to place the disclosure in context only serves to mislead fund shareholders.

The Institute therefore recommends that the after-tax return disclosure rules be amended as follows.[24] First, the formula for computing after-tax returns should use marginal federal ordinary income and long-term capital gains tax rates that are more representative of the average fund investor's tax situation, [25] rather than the highest marginal tax rate. The former rates are far more representative of the average fund investor's tax situation than the latter rate, which significantly overstates the tax consequences of investing for most fund shareholders. Consequently, most investors are receiving tax information that is not applicable or meaningful to them.

Second, we recommend that all hypothetically-redeemed shares (including shares purchased with reinvested dividends) be treated as generating long-term capital gains or losses, rather than looking to the actual period that the shares were held to determine the tax treatment of the gains and losses. It is inappropriate to impose an ordinary income tax rate to the one-year "post liquidation" after-tax return (the gain or loss on which is treated as "short-term) when the applicable rate the very next day would drop to 20 percent (because shares held for one year and one day get long-term capital gain treatment). This treatment (particularly when using the highest tax rate) overstates the tax consequences of investing for approximately (as opposed to exactly) one year. Given that few if any investors ever redeem one day before any tax on a gain would be cut almost in half, it is unrealistic to treat one-year redemption gains as short-term. Finally, there is little if any benefit to be derived from treating any gain or loss on shares acquired by dividend reinvestment during the current calendar year as short-term.

Third, we recommend that the after-tax return disclosure be included in the tax section of a fund's prospectus, rather than the risk/return summary. Investors would benefit if all of the information about the tax consequences of investing in a fund were provided in one central location. In addition, including disclosure of after-tax numbers along with the required extensive narrative disclosure in the risk/return summary may overwhelm other important information included in the summary.

D. Permit Use of the Profile to Support Additional Investments by Existing Fund Shareholders

The Division of Investment Management has been considering possible ways to eliminate the need for funds to deliver full updated prospectuses to existing shareholders that make an investment in the same fund, including by allowing the use of fund profiles for this purpose. [26] As we recommended previously, [27] the Division should recommend that the Commission issue a proposal specifically permitting this use of profiles.

The federal securities laws do not require funds to send an updated prospectus annually to existing shareholders. Nevertheless, many funds do so to ensure that investors have the information necessary to make an informed investment decision, should they wish to make an additional investment in the fund. By routinely sending an updated prospectus to existing shareholders, funds avoid the need to continuously track which investors have received an updated prospectus. Other funds provide existing shareholders with an updated prospectus at the time of confirmation of any additional investment. Either way, fund groups, and ultimately fund shareholders, bear significant printing and mailing costs to provide existing shareholders with updated prospectuses.

The profile would provide an effective way to communicate updated information to existing shareholders. It is a concise document that summarizes the critical information needed to make an investment decision, and thus would provide existing shareholders with updated information in a format that they are likely to read. Also, it would be relatively easy for funds that have not yet created profiles to do so, since the profile incorporates many elements required in the full prospectus (e.g., the risk/return summary). Sending the profile to existing shareholders not only would provide those shareholders with the information they need in a user-friendly format but also ultimately could result in significant cost savings for funds and their shareholders. Of course, any shareholder receiving a profile would be entitled to receive a full prospectus upon request.

E. Eliminate the Form Used to Register Securities Issued in Business Combinations (Form N-14)

The Institute recommends that the Commission substitute the Schedule 14A proxy statement and fund prospectus for Form N-14 in connection with investment company reorganizations. Filings on Form N-14 are unnecessarily burdensome and expensive to funds; conventional proxy statement and prospectus disclosure would be clearer and more concise to investors.

Form N-14 is used to register securities issued by the acquiring investment company in a reorganization of two investment companies that is subject to Rule 145 under the Securities Act of 1933. [28] Form N-14 also may serve as the proxy statement for soliciting the approval of the reorganization by shareholders of the investment company being acquired. The Commission adopted Form N-14 in 1985 for the purpose of simplifying the registration process and improving the disclosure made to investors voting on reorganization proposals. [29]

Form N-14, sometimes called a "merger proxy" or "proxy prospectus," is essentially a complete registration statement and proxy statement combined. The key disclosures relating to the reorganization transaction and participating companies required by Form N-14 are substantially similar to the disclosures required by Schedule 14A under the Exchange Act. [30] A significant portion of the disclosure required by Form N-14 is also derived from Form N-1A (or other corresponding registration form). [31] Only a few disclosure items do not have their source in Schedule 14A or Form N-1A (or other corresponding registration form). The most important of these are pro forma financial statements and numerous additional exhibits. These additional disclosure requirements are of little or no value to investors. Primarily because of the required pro forma financial statements and exhibits, the time and expense necessary to prepare a Form N-14 is significantly greater than preparing a Schedule 14A proxy statement.

Replacing Form N-14 with a conventional proxy statement and the prospectus of the acquiring fund would provide clearer and more concise disclosure to the target fund shareholders. These two clear and understandable documents are best designed to enable investors to make an informed investment decision. One document would present the important disclosures relating to the new investment vehicle under consideration, and the other would describe the reorganization and the differences between the acquiring fund and the fund being acquired.

At the time Form N-14 was adopted, it was thought that a single disclosure document would provide simpler and more understandable disclosure for shareholders. This is no longer true. First, the conventional fund prospectus on Form N-1A (which, unlike Form N-14, has been updated and modernized) sets forth in a more meaningful and readable format the information essential for deciding whether to invest in a new fund. [32] Moreover, a proxy statement prepared in accordance with Schedule 14A would provide a more streamlined format for information about the reorganization decision itself. A reorganization decision is essentially no different from other shareholder decisions, such as approving a change in a fund's investment policy or its investment adviser. Such a decision should not require the more cumbersome combination of a "proxy prospectus." Finally, the use of two separate disclosure documents would better capture the two-fold nature of the decision that the investor has to make—whether to invest in a new fund and whether to do so through a reorganization transaction.

For these reasons, rescinding Form N-14 and replacing it with a conventional proxy statement and a fund prospectus would make disclosure more understandable to the investor. Rescinding the Form also would save investment companies the considerable time and expense associated with preparing the overly detailed and unnecessary pro forma financial statements and exhibits required by Form N-14. The Commission does not require delivery of this type of information to investors in connection with a decision to invest in a fund. Rather, under Form N-1A, the Commission has determined that the prospectus contains the information investors need to make an informed investment decision; financial statements and exhibits are filed with the Commission but not delivered to investors. There is no reason to believe this type of information would be material to shareholders in considering a mutual fund reorganization proposal.

The strict liability standards of Section 11 of the Securities Act for untrue statements or omissions of material fact in a prospectus would, of course, still apply to statements made in the Form N-1A prospectus. While Section 11 liability would not attach to the proxy statement, investors would continue to receive the protections of the antifraud provisions of Rule 14a-9 under the Exchange Act. In addition, material misstatements in both documents would still be subject to Rule 10b-5 under the Exchange Act, since reorganizations involve the purchase and sale of a security. Thus, investors would have substantial and adequate legal remedies for false or misleading statements in connection with the proposed disclosure process for reorganizations.

In sum, the framework for reorganization-related disclosure resulting from rescinding Form N-14—delivery of the N-1A prospectus of the acquiring fund together with a Schedule 14A proxy statement—would provide investors with more useful disclosure documents and would be less expensive and burdensome to investment companies.

F. Amend the Requirement to Disclose the Source of Dividend Payments (Rule 19a-1)

Section 19(a) of the Investment Company Act and Rule 19a-1 thereunder require management investment companies to inform shareholders of the source of dividend payments if any portion of the payment is attributable to a source other than net investment income. In effect, the different sources of dividend payments (net investment income, capital gains, paid-in capital) must be identified. Section 19(a) is intended to ensure that shareholders are properly advised as to the source of any dividends and are not misled into believing that dividend payments from non-recurring sources are of a regular and recurring nature.

There is an inherent problem, however, with the current requirement. Namely, it is rarely possible to know with certainty, at the time of an investment company's dividend payment, the precise nature of amounts included in the distribution. The exact allocation between investment income, capital gains and return of capital cannot be definitively determined until after the investment company's fiscal year-end. Because of this uncertainty, Rule 19a-1 notices are typically qualified with language that warns shareholders that the amounts associated with the stated sources are estimates subject to change, and that final information will be provided in the shareholder's IRS Form 1099-DIV. As a result, investment companies and their shareholders currently bear considerable expense in the form of printing and mailing costs associated with providing information of limited value to investment company shareholders.

For these reasons, the Institute recommends that the Commission replace the dividend source notification currently required under Rule 19a-1 with a requirement that the source of dividend payments be identified in the investment company's annual report to shareholders. [33] (The Institute has furnished a proposed amendment to Rule 19a-1 to implement this recommendation.) This requirement would place the disclosures in the proper context of the investment company's financial statements, thereby permitting shareholders to see the character of their dividend payments along with the investment company's presentation of per share distributions in the financial highlights table.

Proposed Amendments to Rule 19a-1
New language in bold; deleted language underlined and in brackets

Amend paragraph (a) to read as follows:

"(a) Every written statement made pursuant to Section 19 by or on behalf of a management company shall be made in the annual report provided to shareholders pursuant to Rule 30d-1 on a separate paper and shall clearly indicate what portion of the payment per share is made from the following sources:"

G. Improve Financial Statement Disclosure of Capital and Dividends Paid

Rule 6-04 of Regulation S-X requires investment companies to disclose the financial accounting components of capital on the balance sheet (i.e., shareholder capital, undistributed net investment income, undistributed net realized gains, and unrealized appreciation/depreciation). However, investment company shareholder distributions are based on taxable income. Generally accepted accounting principles (GAAP) for investment companies were recently changed to collapse the components of capital on the balance sheet into two categories: paid in capital and distributable earnings. [34] In addition, GAAP now requires funds to disclose the tax-basis components of distributable earnings (i.e., undistributed ordinary income, undistributed long-term capital gains, capital loss carryforwards, and unrealized appreciation/depreciation) in the financial statement footnotes. This change is intended to better enable investors to determine the amount of accumulated and undistributed earnings that could be paid out to investors as taxable distributions in the future.

Rule 6-09 of Regulation S-X requires investment companies to disclose in the Statement of Changes in Net Assets dividends paid from net investment income, realized gains, and other sources. Similarly, Item 9 of Form N-1A requires funds to disclose in the financial highlights dividends paid from net investment income, realized gains, and any return of capital. GAAP for investment companies was recently changed to require that dividends paid be disclosed as a single line item in the Statement of Changes in Net Assets and the Financial Highlights (except that any return of capital on a tax basis would be disclosed as a second line item). In addition, GAAP now requires funds to disclose the tax-basis components of dividends paid in the financial statement footnotes. This disclosure is consistent with the manner in which dividends are reported to shareholders at calendar year end on IRS Form 1099-DIV.

These changes simplify the presentation of capital and dividends paid in the financial statements while providing shareholders better tax-basis information on current and possible future distributions. However, funds cannot fully take advantage of these changes until the Commission amends its financial reporting rules. We recommend that the Commission amend the investment company financial reporting rules and form requirements relating to capital and dividends paid so that they conform to GAAP.

III. Recommendations to Amend Other Investment Company Act Rule

A. Amend the "Independent Legal Counsel" Provisions (Rule 0-1(a)(6))

Last year, the Commission adopted new fund governance provisions that are designed to enhance the independence and effectiveness of independent fund directors. [35] The governance provisions, among other things, added new conditions to a set of ten exemptive rules under the Investment Company Act upon which funds regularly rely in their day-to-day operations. [36] One such condition is that the independent directors of any fund seeking to rely on these exemptive rules must determine that any legal counsel retained to represent the independent directors is an "independent legal counsel" as defined in Rule 0-1(a)(6) under the Act. [37]

Since the new fund governance rules were adopted, concerns have arisen regarding the independent legal counsel provisions. One significant concern relates to the potential for retroactive loss of exemptive relief if a determination by directors that counsel is independent is overturned. Under the new rules, independent directors are permitted to conclude that counsel representing a fund's investment adviser, principal underwriter or administrator (management organizations) or their control persons may nonetheless be deemed an independent legal counsel, if any representation of these entities is "sufficiently limited." In these circumstances, the inherently subjective nature of the independent directors' determination raises the prospect that the determination could be second-guessed. If so, funds and their advisers could be faced with challenges that they were not entitled to rely on certain exemptive rules. Even if such challenges are unlikely to be successful, the potential consequences are so severe that they could act to discourage independent directors from retaining counsel in circumstances in which Rule 0-1(a)(6) was not intended to disqualify such counsel.

The potential for retroactive loss of exemptive relief also could exist if independent directors subsequently discover that counsel is not in fact "independent" within the meaning of the new rules, despite good faith reliance by the independent directors on counsel's representations. In addition, because the independent legal counsel condition added to the exemptive rules applies by its terms to any legal counsel selected and retained by independent fund directors for any purpose, there are concerns that it would restrict the independent directors' ability to retain "special counsel" in matters not involving significant conflicts of interest between funds and fund management.

The Division of Investment Management recently issued a letter to the Institute regarding these issues.[38] Although the staff's letter provides some comfort, it would be far preferable for the rules themselves to be clear on these points. For example, while the views articulated in the staff's letter might provide useful guidance to a court should these issues be litigated, rule changes would provide more definitive guidance. In addition, rule changes would provide greater certainty to independent directors and funds as to the funds' continuing ability to rely on key exemptive rules.

The staff's letter notes that the fund governance rules will be considered in the context of the planned comprehensive review of all Commission regulations. The Institute still questions the advisability of the independent legal counsel requirement. [39] If it is retained, however, we strongly recommend that the Commission revise the fund governance rules in order to codify, in essence, the positions expressed in the staff's letter concerning independent legal counsel.

Specifically, we recommend amending Rule 0-1(a)(6) to provide that a person determined to be an independent legal counsel pursuant to the rule will be deemed as such for purposes of satisfying the independent legal counsel condition of the affected exemptive rules unless and until the Commission issues an order finding that such determination was not reasonable. In addition, Rule 0-1(a)(6) should allow the independent directors to continue to deem that counsel independent for purposes of relying on the exemptive rules for up to three months from the effective date of a Commission order. The rule also should make clear that such an order would have no impact on a fund's reliance on the exemptive rules prior to the date of the order. This approach is analogous to the provisions of Section 2(a)(19) of the Investment Company Act that authorize the Commission to issue an order finding an independent director to be an "interested person" of a fund due to a "material business relationship." Such an order is prospective only.

Rule 0-1(a)(6) should be further amended to provide that a fund would not lose the ability to rely on the exemptive rules if independent directors learn that information previously provided by counsel and relied upon to make the required independence determination was materially false or incomplete, so long as within three months of learning of the incorrect information, the directors determine that counsel meets the definition of an independent legal counsel notwithstanding the new information.

Finally, the Commission should amend the independent legal counsel provision in each of the relevant exemptive rules to provide that any person who provides services as a "special counsel" to the independent directors of a fund need not be an independent legal counsel within the meaning of Rule 0-1(a)(6). In conjunction with this change, the Commission should adopt a new Rule 0-1(a)(7) that would define a "special counsel" with respect to the independent directors of a fund to be a person whose representation does not relate materially to matters affecting the directors' independent review and judgment in carrying out their responsibilities under the relevant exemptive rules.

Consistent with the staff's letter, the rule changes we propose would address the concerns raised by the independent legal counsel provisions in a narrowly targeted manner, without materially altering the intended operation of those provisions or any other aspect of the new fund governance rules.

Rule language to implement these recommendations is set forth below.

Proposed Amendments to the Independent Legal Counsel Provisions
New language in bold; deleted language underlined and in brackets

1. Amend paragraph (a) of Rule 0-1 to read as follows:

(a) * * *

(6)(i) A person is an independent legal counsel with respect to the directors who are not interested persons of an investment company (disinterested directors) if:

(A) A majority of the disinterested directors reasonably determine in the exercise of their judgment (and record the basis for that determination in the minutes of their meeting) that any representation by the person of the company's investment adviser, principal underwriter, administrator (management organizations), or any of their control persons, since the beginning of the fund' company's last two completed fiscal years, is or was sufficiently limited that it is unlikely to adversely affect the professional judgment of the person in providing legal representation to the disinterested directors; and

(B) The disinterested directors have obtained an undertaking from such person to provide them with information necessary to make their determination and to update promptly that information when the person begins to represent, or materially increases his representation of, a management organization or control person.

(ii) The disinterested directors are entitled to rely on the information obtained from the person, unless they know or have reason to believe that the information is materially false or incomplete. The disinterested directors must re-evaluate their determination no less frequently than annually (and record the basis accordingly), except as provided in paragraph (iii) of this section.

(iii) After If, after making a determination that a person is an independent legal counsel pursuant to paragraph (a)(6)(i) of this section in reliance on information obtained from the person, the disinterested directors obtain become aware of additional information that causes them to conclude or have reason to believe either that the information provided by the person and relied on to amek their determination was materially false or incomplete, or become aware that the person has begun to represent, or has materially increased his representation of, a management organization (or any of its control persons), the person may continue to be deemed an independent legal counsel, for purposes of paragraph (a)(6)(i) of this section, for up to no longer than three months from the date the disinterested directors became aware of the additional information, unless during that period the disinterested directors make a new determination under that paragraph.

(iv) If a determination that a person is an independent legal counsel is made pursuant to paragraph (a)(6)(i) of this section, and the disinterested directors have not become aware of additional information that would cause them to revise or reconsider the determination pursuant to paragraph (a)(6)(iii) of this section, the person will be deemed to be an independent legal counsel from the date of such determination, unless the Commission, by order, finds that the determination was not reasonable. In the event the Commission issues an order finding that the determination was not reasonable, the ability to rely on any rule under the Act that is conditioned on a personacting as legal counsel for the disinterested directors of an investment company being an independent legal counsel will continue for up to three months from the effective date of such order. No order issued by the Commission pursuant to this paragraph (a)(6)(iv) will affect the ability of an investment company to rely on any rule under the Act prior to the effective date of such order.

(iv)(v) For purposes of paragraphs (a)(6)(i) - (iii)(iv) of this section:

(A) The term person has the same meaning as in section 2(a)(28) of the Act (15 U.S.C. 80a-2(a)(28)) and, in addition, includes a partner, co-member, or employee of any person; and

(B) The term control person means any person (other than an investment company) directly or indirectly controlling, controlled by, or under common control with any of the investment company's management organizations.

(7)(i) A person is a special counsel with respect to the directors who are not interested persons of an investment company (disinterested directors) if the person’s representation, since the beginning of the company’s last two completed fiscal years, is or was limited to matters that do not involve, to a material extent, the disinterested directors’ duties or responsibilities in connection with section 10(f) 15 U.S.C. 80a-10(f) of the Act as it relates to the operation of rule 10f-3 17 CFR 270.10f-3 thereunder; section 12(b) 15 U.S.C. 80a-12(b) of the Act as it relates to the operation of rule 12b-1 17 CFR 270.12b-1 thereunder; section 15(a) 15 U.S.C. 80a-15(a) of the Act as it relates to the operation of rule 15a-4(b)(2) 17 CFR 270.15a-4(b)(2) thereunder; section 17(a) 15 U.S.C. 80a-17(a)of the Act as it relates to the operation of rules 17a-7 17 CFR 270.17a-7 and 17a-8 17 CFR 270.17a-8 thereunder; section 17(d) 15 U.S.C. 80a-17(d) of the Act as it relates to the operation of rule 17d-1(d)(7) 17 CFR 270.17d-1(d)(7) thereunder; section 17(e) 15 U.S.C. 80a-17(e)of the Act as it relates to the operation of rule 17e-1 17 CFR 270.17e-1 thereunder; section 17(g) 15 U.S.C. 80a-17(g) of the Act as it relates to the operation of rule 17g-1(j) 17 CFR 270.17g-1(j) thereunder; section 18(f) 15 U.S.C. 80a-18(f) of the Act as it relates to the operation of rule 18f-3 17 CFR 270.18f-3 thereunder; and section 23(c) 15 U.S.C. 80a-23(c) of the Act as it relates to the operation of rule 23c-3 >17 CFR 270.23c-3 thereunder.

(ii) For purposes of paragraph (a)(7)(i) of this section, the term person has the same meaning as in section 2(a)(28) of the Act (15 U.S.C. 80a-2(a)(28)) and, in addition, includes a partner, co-member, or employee of any person.

2. Amend the independent legal counsel condition in each relevant exemptive rule[40] as follows:

* * *

Any person who acts as legal counsel for the disinterested directors, other than a person who provides services as a special counsel, is an independent legal counsel.

B. Amend the Rule Governing Exchanges (Rule 11a-3)

Section 11(a) of the Investment Company Act generally prohibits a registered open-end investment company from making an exchange offer with respect to its shares or those of another open-end investment company on any basis other than the relative net asset values of the securities to be exchanged, except with prior Commission approval or pursuant to Commission rules. Rule 11a-3 under the Investment Company Act provides an exemption that allows the imposition of a sales charge, redemption fee, administrative fee, or any combination of such fees on the security to be acquired in an exchange, but only if a detailed series of conditions is met. The Institute recommends that the Commission amend 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.

First, we recommend that the Commission delete paragraph (b)(8) of Rule 11a-3, which generally requires 60 days' prior notice to fund shareholders before an exchange offer can be terminated or its terms materially amended. This requirement unduly constrains funds' ability to determine that, due to changing business conditions or other factors, their shareholders would be better served by a different exchange program, or perhaps even no exchange program. There is no basis for the notice requirement in the legislative history of the Investment Company Act, and it inappropriately implies that exchange privileges are something more than privileges. Section 11 is intended to restrict the terms of exchange offers in order to discourage "switching"; it does not create a vested right in existing exchange offers.

In proposing the notice requirement, the Commission indicated that it was needed for reasons of fairness to shareholders who may have purchased shares in reliance upon the existence of an exchange offer with the specific terms set forth in the prospectus. [41] Any such reliance would not be reasonable, however, given that Rule 11a-3 specifically requires disclosure in prospectuses of funds that offer exchanges, if the offering company reserves the right to change the terms of or terminate an exchange offer, that the exchange offer is subject to termination and its terms are subject to change. Moreover, a notice requirement in this context is anomalous when one considers that no such requirement applies to changes to other services that funds may provide, such as redemptions by telephone.

For similar reasons, we recommend that subparagraph (b)(7)(ii) of the rule be deleted. That provision requires the same disclosure in sales literature or advertising that mentions the existence of an exchange offer as is required in fund prospectuses when a fund reserves the right to change the terms of or terminate an exchange offer. Especially given the requirement for prospectus disclosure, this disclosure is not necessary. Requiring such "boilerplate" disclosure ignores the basic principle that investors should read the prospectus before purchasing fund shares. Moreover, in the prospectus, the disclosure is presented in context. It is neither possible nor appropriate to include all relevant information in fund advertisements and sales literature. Like the notice requirement, this disclosure requirement inappropriately implies that the terms of an exchange program are among the most important characteristics of a fund.

Second, we recommend that the Commission delete paragraph (b)(3) of Rule 11a-3, which prohibits the imposition of a deferred load on an exchanged security at the time of the exchange. In addition, we recommend that the Commission delete paragraph (b)(9), which sets forth requirements concerning the calculation of sales loads with respect to exchanged shares where an investor exchanges less than all of his securities and in the case of exchanged shares acquired through reinvestment of dividends or capital gains distributions. Similar types of provisions were eliminated from Rule 6c-10 when it was amended in 1996, on the theory that appropriate disclosure and the NASD's limits on sales charges provide adequate protection. The same theory is equally applicable in the context of Rule 11a-3.

Third, we recommend changes to paragraphs (b)(4) and (b)(5) of the rule to accommodate installment loads. Paragraph (b)(4) generally provides that a sales load imposed on an acquired security may not exceed the difference between the sales load applicable to that security in the absence of an exchange and all sales loads previously paid on the exchanged security. By referring to "any sales load charged," this provision creates an ambiguity in the case of an installment load. To illustrate, if an investor purchased a fund with a 3 percent front-end load (Fund A), and subsequently exchanged into a fund that imposed an installment load of 1 percent for five years (Fund B), the rule could be read not to permit any load to be charged on the Fund B shares, because the investor already paid a 3 percent load (which is greater than 1 percent). This would produce an illogical result. The relevant comparison is between the load already paid and the aggregate amount of an installment load (i.e., 5 percent in the above example), rather than the amount of an individual installment payment. The rule should be revised accordingly.

Paragraph (b)(5) governs the determination of an investor's holding period for purposes of computing the applicable deferred sales load and requires, generally, that the time during which the investor held the exchanged security be taken into account. This requirement only makes sense, however, in the case of a contingent deferred sales load and does not work where the acquired fund imposes an installment load. Thus, using the funds described in the preceding paragraph to illustrate, if an investor purchased shares of Fund A (which has a 3 percent front-end load), held them for five years, and then exchanged into Fund B (which imposes an installment load of 1 percent for five years), paragraph (b)(5) would seem to prohibit Fund B from imposing any further load, because Fund B does not impose any load after five years. Yet it is more appropriate to treat an installment load like a front-end sales load for this purpose; the holding period is irrelevant. To the extent the load previously paid is lower than the load that normally would apply to the acquired security, the second fund should be permitted to charge a load that does not exceed the difference between these two (pursuant to paragraph (b)(4) as we suggest it should be clarified above). To accomplish this result, paragraph (b)(5) should be modified to apply only to contingent deferred sales loads. [42]

We also recommend the deletion of paragraph (d) of Rule 11a-3, which is obsolete.

Rule language to implement our recommendations is set forth below.

Proposed Amendments to Rule 11a-3
New language in bold; deleted language underlined and in brackets

(a) For purposes of this rule:

(1) Acquired security means the security held by a securityholder after completing an exchange pursuant to an exchange offer;

(2) Administrative fee means any fee, other than a sales load, deferred sales load or redemption fee, that is

(i) reasonably intended to cover the costs incurred in processing exchanges of the type for which the fee is charged, Provided that: the offering company will maintain and preserve records of any determination of the costs incurred in connection with exchanges for a period of not less than six years, the first two years in an easily accessible place. The records preserved under this provision shall be subject to inspection by the Commission in accordance with section 31(b) of the Act 15 U.S.C. 80a-30(b) as if such records were records required to be maintained under rules adopted under section 31(a) of the Act 15 U.S.C. 80a-30a); or

(ii) a nominal fee as defined in paragraph (a)(10) of this section;

(3) Contingent deferred sales load means any amount properly chargeable to sales or promotional expenses that is paid by a shareholder upon redemption, which declines over a specified period of time after purchase until the amount reaches zero;

(4) Deferred sales load means any amount properly chargeable to sales or promotional expenses that is paid by a shareholder after purchase but before or upon redemption, and includes a contingent deferred sales load and an installment load;

(5) Exchanged security means

(i) the security actually exchanged pursuant to an exchange offer, and

(ii) any security previously exchanged for such security or for any of its predecessors;

(6) Group of investment companies means any two or more registered open-end investment companies that hold themselves out to investors as related companies for purposes of investment and investor services, and

(i) that have a common investment adviser or principal underwriter, or

(ii) the investment adviser or principal underwriter of one of the companies is an affiliated person as defined in section 2(a)(3) of the Act (15 U.S.C. 80a-2(a)(3) of the investment adviser or principal underwriter of each of the other companies;

(7) Installment sales load means any amount properly chargeable to sales or promotional expenses that is to be paid by a shareholder over a specified period of time in a series of two or more successive payments.

(8) Offering company means a registered open-end investment company (other than a registered separate account) or any principal underwriter thereof that makes an offer (an exchange offer) to the holder of a security of that company, or of another open-end investment company within the same group of investment companies as the offering company, to exchange that security for a security of the offering company;

(9) Redemption fee means any fee (other than a sales load, deferred sales load or administrative fee) that is paid to the fund and is reasonably intended to compensate the fund for expenses directly related to the redemption of fund shares; and

(10) Nominal fee means a slight or de minimis fee.

(b) Notwithstanding section 11(a) of the Act 15 U.S.C. 80a-11(a), and except as provided in paragraphs (d) and (e) of this section, in connection with an exchange offer an offering company may cause a securityholder to be charged a sales load on the acquired security, a redemption fee, an administrative fee, or any combination of the foregoing, Provided that:

(1) Any administrative fee or scheduled variation thereof is applied uniformly to all securityholders of the class specified;

(2) Any redemption fee charged with respect to the exchanged security or any scheduled variation thereof

(i) is applied uniformly to all securityholders of the class specified, and

(ii) does not exceed the redemption fee applicable to a redemption of the exchanged security in the absence of an exchange.

Any scheduled variation of a redemption fee must be reasonably related to the costs to the fund of processing the type of redemptions for which the fee is charged;

(3) No deferred sales load is imposed on the exchanged security at the time of an exchange;

(3) (4) Any sales load (or, with respect to an installment sales load, the sum of the rates of all payments made under such load) charged with respect to the acquired security is a percentage that is no greater than the excess, if any, of the rate of the sales load (or, with respect to an installment sales load, the sum of the rates of all payments to be made under such load) applicable to that security in the absence of an exchange over the sum of the rates of all sales loads previously paid on the exchanged security, Provided that:

(i) the percentage rate of any sales load charged when the acquired security is redeemed, that is solely the result of a contingent deferred sales load imposed on the exchanged security, may be no greater than the excess, if any, of the applicable rate of such sales load, calculated in accordance with paragraph (b)(4) of this section, over the sum of the rates of all sales loads previously paid on the acquired security, and;

(ii) in no event may the sum of the rates of all sales loads imposed prior to and at the time the acquired security is redeemed, including any sales load paid or to be paid with respect to the exchanged security, exceed the maximum sales load rate, calculated in accordance with paragraph (b)(4) of this section, that would be applicable in the absence of an exchange to the security (exchanged or acquired) with the highest such rate;

(4) (5) Any contingent deferred sales load charged at the time the acquired security is redeemed is calculated as if the holder of the acquired security had held that security from the date on which he became the holder of the exchanged security, Provided that:

(i) the time period during which the acquired security is held need not be included when the amount of the contingent deferred sales load is calculated, if the contingent deferred sales load is

(A) reduced by the amount of any fees collected on the acquired security under the terms of any plan of distribution adopted in accordance with rule 12b-1 under the Act 17 CFR 270.12b-1 (a 12b-1 plan), and

(B) solely the result of a sales load imposed on the exchanged security, and no other sales loads, including contingent deferred sales loads, are imposed with respect to the acquired security,

(ii) the time period during which the exchanged security is held need not be included when the amount of the contingent deferred sales load on the acquired security is calculated, if

(A) the contingent deferred sales load is reduced by the amount of any fees previously collected on the exchanged security under the terms of any 12b-1 plan, and

(B) the exchanged security was not subject to any sales load, and

(iii) the holding periods in this subsection may be computed as of the end of the calendar month in which a security was purchased or redeemed;

(5) (6) The prospectus of the offering company discloses

(i) the amount of any administrative or redemption fee imposed on an exchange transaction for its securities, as well as the amount of any administrative or redemption fee imposed on its securityholders to acquire the securities of other investment companies in an exchange transaction, and

(ii) if the offering company reserves the right to change the terms of or terminate an exchange offer, that the exchange offer is subject to termination and its terms are subject to change;

(6) (7) Any sales literature or advertising that mentions the existence of the exchange offer also discloses

(i) the existence of any administrative fee or redemption fee that would be imposed at the time of an exchange; and

(ii) if the offering company reserves the right to change the terms of or terminate the exchange offer, that the exchange offer is subject to termination and its terms are subject to change;<</p>

(8) Whenever an exchange offer is to be terminated or its terms are to be amended materially, any holder of a security subject to that

offer shall be given prominent notice of the impending termination or amendment at least 60 days prior to the date of termination or the effective date of the amendment, Provided that:

(i) no such notice need be given if the only material effect of an amendment is to reduce or eliminate an administrative fee, sales load or redemption fee payable at the time of an exchange, and

(ii) no notice need be given if, under extraordinary circumstances, either

(A) there is a suspension of the redemption of the exchanged security under section 22(e) of the Act 15 U.S.C. 80a-22(e) and the rules and regulations thereunder, or

(B) the offering company temporarily delays or ceases the sale of the acquired security because it is unable to invest amounts effectively in accordance with applicable investment objectives, policies and restrictions; and

<(9) In calculating any sales load charged with respect to the acquired security:

(i) if a securityholder exchanges less than all of his securities, the security upon which the highest sales load rate was previously paid is deemed exchanged first; and

(ii) if the exchanged security was acquired through reinvestment of dividends or capital gains distributions, that security is deemed to have been sold with a sales load rate equal to the sales load rate previously paid on the security on which the dividend was paid or distribution made.

(c) If either no sales load is imposed on the acquired security or the sales load imposed is less than the maximum allowed by paragraph (b)(3) of this section, the offering company may require the exchanging securityholder to have held the exchanged security for a minimum period of time previously established by the offering company and applied uniformly to all securityholders of the class specified.

(d) Any offering company that has previously made an offer of exchange may continue to impose fees or sales loads permitted by an order under section 11(a) of the Act upon shares purchased before the earlier of

(1) one year after the effective date of this section, or

(2) when the offer has been brought into compliance with the terms of this section, and upon shares acquired through reinvestment of dividends or capital gains distributions based on such shares, until such shares are redeemed.

(d) (e)Any offering company that has previously made an offer of exchange cannot rely on this section to amend such prior offer unless

(1) the offering company's prospectus disclosed, during at least the two year period prior to the amendment of the offer (or, if the fund is less than two years old, at all times the offer has been outstanding) that the terms of the offer were subject to change, or

(2) the only effect of such change is to reduce or eliminate an administrative fee, sales load or redemption fee payable at the time of an exchange.

C. Amend the Rule Concerning Investments in Securities Related Businesses (Rule 12d3-1)

Section 12(d)(3) of the Investment Company Act prohibits, with certain limited exceptions, investment companies from acquiring “any security issued by or any other interest in the business of any person who is a broker, a dealer, is engaged in the business of underwriting, or is either an investment adviser of an investment company or an investment adviser registered under the Investment Advisers Act of 1940.” Rule 12d3-1(a) under the Act exempts from Section 12(d)(3) investments in issuers that derive 15 percent or less of their gross revenues from “securities related activities.” [43] Rule 12d3-1(b) permits investment companies to acquire the securities of issuers that derive more than 15 percent of their gross revenues from “securities related activities,” provided that: (1) immediately after the acquisition of any equity security, the company owns less than five percent of the outstanding securities of that class of the issuer’s equity securities; (2) immediately after the acquisition of any debt security, the company owns less than ten percent of the outstanding principal amount of the issuer’s debt securities; and (3) immediately after any such acquisition, the acquiring company has invested not more than five percent of the value of its total assets in the securities of the issuer (the five percent asset limit). Rule 12d3-1(c) provides that, notwithstanding the foregoing, the rule does not exempt the acquisition of a general partnership interest or of a security issued by the acquiring company’s investment adviser, promoter, principal underwriter, or an affiliated person of such adviser, promoter, or underwriter.

Although Rule 12d3-1 provides some relief from the prohibition in Section 12(d)(3), it is more restrictive than is necessary to promote the goals of Section 12(d)(3), to the detriment of fund shareholders. [44] The Institute recommends that Rule 12d3-1 be amended to avoid unduly constraining funds from taking advantage of attractive investment opportunities, consistent with the purposes of Section 12(d)(3). In particular, as discussed below, we recommend that the Commission amend Rule 12d3-1 to (1) increase the five percent asset limit to ten percent, and (2) codify exemptive relief in which the Commission has allowed a discrete portion of a multi-managed fund to invest in securities issued by an unaffiliated investment adviser (or its affiliate) to another portion of the fund. [45]

1. The Five Percent Asset Limit

The Commission has recognized that Section 12(d)(3) is intended to address two potentially abusive reciprocal practices. First, an investment company might purchase the securities of a broker-dealer to reward it for selling the investment company's shares. Second, an investment company might direct brokerage transactions to a broker-dealer in which the investment company had an investment, in order to enhance the broker-dealer's profitability. [46] The five percent asset limit is intended, along with the limits on investments in a securities related issuer's equity and debt securities (investment limits) to "minimize the potential for conflicts of interest and reciprocal practices by preventing an investment company from acquiring a significant stake in any particular broker or dealer." [47] While the asset limit is designed to address the potential abuses that the Commission had in mind in adopting Rule 12d3-1, there does not seem to be any reason that the limit should be five percent. [48] When it adopted Rule 12d3-1, the Commission stated: "In view of the broad prohibition in the [Investment Company] Act against investment company acquisitions of interests in issuers engaged in securities related activities, the Commission believes that any exemptive relief must be conditioned upon certain quantitative limitations. The proposed amendments impose reasonable limits on such acquisitions and are therefore adopted." [49] For the reasons discussed below, the five percent asset limit is no longer "reasonable."

The five percent asset limit hinders some investment companies from meeting their investment objectives, policies, and/or strategies. In an era of increasing consolidation in the financial services sector, certain securities related issuers represent more than five percent of the capitalization of the sector. [50] Funds that wish to invest in accordance with this relative weighting must invest more than five percent of their assets in the securities of certain financial services companies. [51] Similarly, certain securities related issuers represent a larger percentage of the broader market than they did in the past. [52] Some actively managed funds with an investment policy or strategy of investing primarily in the securities of large-capitalization issuers have found that it would be desirable and in accordance with their investment objectives, policies and strategies to invest more than five percent of the fund's assets in these securities related issuers.

A ten percent limit would enhance the ability of funds such as those described above to fulfill their investment objectives, policies and strategies while still providing protection against the abusive reciprocal practices that the rule was designed to address. First, the rule's investment limits would remain unchanged. Investment limits are the most significant safeguards provided by the rule: they focus squarely on reciprocal practices by directly limiting the amount of capital that a fund can place at the disposal of a broker-dealer. In addition, an increase in the asset limit from five to ten percent represents only an incremental adjustment in the rule's protections. Moreover, in recent years, the Commission has put into place additional safeguards to prevent the potential conflicts of interest presented by investments in broker-dealers: the Commission recently adopted rule amendments designed to strengthen the positions of independent directors to serve as "watchdogs" for fund shareholders. [53] An important responsibility of fund directors is to oversee fund brokerage allocations.

For these reasons, the Institute recommends that Rule 12d3-1 be amended to increase the asset limit from five to ten percent.

2. Codification of Relief Granted to Multi-Managed Funds

An increasing number of investment companies today employ multiple unaffiliated subadvisers to make investment decisions for a discrete portion of fund assets assigned to that subadviser. Each such subadviser has no authority regarding the remainder of the fund's portfolio. Nevertheless, because each unaffiliated subadviser is considered to be an adviser to the entire multi-managed fund, the portion of the fund assets managed by such unaffiliated subadviser would be prohibited by Rule 12d3-1(c) from investing in issuers that are subadvisers to, or affiliated with a subadviser to, a different portfolio segment.

As a result, in the past several years, a number of investment companies have requested and received exemptive relief from the Commission to permit a separately managed portion of a multi-managed fund to invest in securities issued by the subadviser (or its affiliate) to another portion of the fund, provided that the other conditions of Rule 12d3-1 are met. [54] In these cases the petitioners have argued that, where each subadviser acts independently of the other subadvisers in making investment decisions, the potential conflicts of interest that Rule 12d3-1(c) was designed to address would not likely exist. Recognizing the validity of this argument, the Commission now routinely grants such relief.

Because the exemptive application process is costly and time consuming for both the staff and petitioners, the Commission frequently codifies routinely granted exemptive relief. Accordingly, the Institute recommends that the Commission amend Rule 12d3-1 to provide relief from subparagraph (c) of the rule in the circumstances described above.

D. Amend the Self-Custody Rule (Rule 17f-2)

Section 17(f) of the Investment Company Act seeks to protect registered management investment companies and their shareholders against the risk of loss by prescribing qualifications for custodians of the fund's portfolio assets. In addition, Section 17(f) permits a registered management investment company to maintain its securities and similar assets with itself—i.e., it may "self-custody"—but only in accordance with such rules as may be prescribed by the Commission. Rule 17f-2 sets forth those rules.

Rule 17f-2 provides, in pertinent part, that self-custodied securities must be deposited "in the safekeeping of, or in a vault or other depository maintained by" a bank or other federally- or state-supervised company, that those assets must be "physically segregated at all times" and that access to those securities by fund personnel must be limited to no more than five board-designated persons, at least two of whom must act jointly to obtain access. The rule further specifies that persons depositing, withdrawing or ordering the delivery (e.g., a transfer for purposes of sale) of self-custodied securities must sign "notations" showing, among other things, the "identification" of the relevant securities "by certificate numbers or otherwise," and that notations must be transmitted to another board-designated person. Finally, the rule requires that the securities be "verified by actual examination" by the fund's independent auditors at least three times a year, at least two of which must be surprise examinations performed "without prior notice" to the fund. Pursuant to an accounting release issued promptly after the adoption of Rule 17f-2, [55] the Commission has construed this examination requirement to mean that fund auditors must "make a physical examination of the self-custodied securities," or in "certain" unspecified, cases "obtain confirmation," and that the auditors must "reconcile the physical count or confirmation with the book records."

The Institute recommends that Rule 17f-2 be revised to: (1) eliminate existing obstacles to the ability of investment companies to self-custody uncertificated securities (including uncertificated shares of other mutual funds); (2) make less onerous the procedures that investment companies must undertake to protect against the theft or misappropriation of self-custodied securities; and (3) provide separately for any special requirements applicable to the use of affiliated custodians, rather than continue to treat such use as self-custody.

1. Self-Custody of Uncertificated Securities

Rule 17f-2 was adopted in 1941, [56] when virtually all securities were issued in certificated form and when securities ownership normally entailed physical possession of the securities certificates. Accordingly, as reflected by the provisions described above, the rule specifically contemplates the safekeeping of physical securities in a secure environment (such as a vault), subject to controls designed to protect against the theft or misappropriation of physical certificates by dishonest fund officers, investment advisers or their employees.

Today, however, many securities are uncertificated, [57] and a substantial portion of these uncertificated securities are owned by investment companies. Uncertificated securities include the shares of most mutual funds, virtually all U.S. government debt, most mortgage- and asset-backed securities, and a growing number of money market and other debt securities. There is nothing in Section 17(f) to suggest that Congress intended for investment companies to be able to self-custody certificated securities but not uncertificated securities. Nevertheless, those provisions of Rule 17f-2 that envision the self-custody of only certificated securities constitute obstacles to the self-custody of uncertificated securities.

One area where this has been a problem is when a fund invests in another fund. Funds that hold shares of other mutual funds—whether in a fund of funds structure, pursuant to cash sweep arrangements, or by investing cash reserves in a money market fund—can realize cost savings by holding the shares of the issuing funds directly (i.e., by becoming the registered owners of the shares on the issuing funds' books) rather than indirectly through a custodian. Both the staff and the Commission have recognized the appropriateness of such direct holdings. The staff has taken no-action positions allowing a fund of funds to hold shares directly with the issuing funds' transfer agents, subject to conditions that effectively adapt the Rule 17f-2 requirements to accommodate uncertificated securities. [58] Similarly, in its recent proposal to amend Rule 17f-4, the Commission has proposed to allow funds to maintain shares of other mutual funds with the issuing funds' transfer agents by treating those transfer agents as the operators of securities depositories for purposes of Rule 17f-4. [59]

As indicated in our comment letter on the Rule 17f-4 Proposal, [60] we agree that funds should be able to hold shares of other investment companies directly—i.e., to self-custody those shares without being impeded by requirements under Rule 17f-2 that were conceived in the context of maintaining physical possession of certificated securities. We also believe that funds should be able to self-custody other uncertificated securities. Accordingly, we recommend that Rule 17f-2 be revised to accommodate such direct holdings by eliminating or modifying those current requirements noted above that make self-custody of uncertificated securities impracticable (e.g., physical segregation, verification by actual examination, etc.).

2. Safeguards Against Theft or Misappropriation

Regardless of whether securities that a fund holds directly are certificated or uncertificated, many of Rule 17f-2's existing requirements impose procedural burdens on self-custodying funds that are disproportionate to the protections that they provide. These overly burdensome procedures should be streamlined, and in some cases eliminated, to make self-custody practicable in those cases where it would result in operational efficiencies.

More specifically, consistent with the spirit and purpose of the current requirements of Rule 17f-2, we recommend amending the rule to require that:

- self-custodying funds deposit their directly held, certificated securities for safekeeping in a vault or other depository maintained by a bank or with another, comparably supervised organization, and that those certificated securities be segregated from other assets;
- self-custodying funds implement internal control systems that are reasonably designed to prevent unauthorized instructions, withdrawals or transfers with respect to self-custodied securities, whether certificated or uncertificated; and
- such control systems be reviewed by the fund's outside auditors on at least an annual basis, with appropriate reporting to the fund's board.

Conversely, however, we believe that many of the specific and detailed requirements currently imposed by Rule 17f-2 should be eliminated because they: (i) provide little or no practical benefit; and (ii) can interfere with the timely effectuation of the fund's ordinary business of buying and selling portfolio securities. These include limitations on the number of fund personnel authorized to "access" self-custodied securities, requirements that the board specifically designate those persons, detailed requirements as to the "notations" that must be made by those authorized persons whenever they take actions with respect to the self-custodied assets, and the requirements for multiple and surprise audits.

The primary purpose of these requirements seems clearly to be the prevention of theft or misappropriation of a self-custodying fund's assets by the fund's investment adviser or by dishonest personnel. Other provisions of the Investment Company Act, however, are also designed to protect against those same risks. Fund advisers and officers have fiduciary responsibilities to the fund, and Section 37 of the Act makes the theft, conversion or embezzlement of fund securities or other assets a federal crime. Moreover, while even requirements as stringent as those of current Rule 17f-2 cannot ensure that there will never be theft or fraud, Section 17(g) and Rule 17g-1 require funds to maintain adequate fidelity bond coverage with respect to any person having access to a fund's securities or other assets.

In light of these protections, we recommend that the detailed requirements of Rule 17f-2 be modified in the manner described above.

3. Treatment of Affiliated Custodians

The staff has interpreted Rule 17f-2 to apply to funds whose bank custodians are affiliated with the fund's investment adviser. The staff has indicated that this interpretation is based on a concern that the policies underlying Rule 17f-2 "would be frustrated if an investment adviser rendering custodial services were not subject to additional safeguards such as those in Rule 17f-2." [61] However, the staff's interpretation has been applied broadly to cover not only situations when the adviser itself (or a separate division thereof) is the fund's custodian, but also when the adviser is a sub-custodian [62] or when the custodian is a separate but affiliated bank. [63] Moreover the staff has required compliance with Rule 17f-2 even when the affiliated custodian used unaffiliated sub-custodians and when the fund had established internal controls or similar safeguards to protect against the risks envisioned by Rule 17f-2. [64]

The Institute agrees that special safeguards, whether internal or regulatory, may be needed to protect against possible abuses when a fund uses an affiliated custodian. We do not believe, however, that such arrangements should be considered tantamount to self-custody or that all of the current requirements of Rule 17f-2 should be applied to affiliated custodians. Indeed, imposing those requirements on affiliated custodians creates substantial distortions. For example, as indicated above, a fund that holds securities through a "securities intermediary"—which would include an affiliated bank custodian—holds those shares "indirectly" and, thus, only in a book entry form. If use of an affiliated custodian means that these indirectly held securities are subject to the requirements of Rule 17f-2, then all of the problems described above with respect to uncertificated securities would apply equally to certificated securities "held" by the custodian. Funds are not in a position to perform physical counts or similar inspections of securities held "indirectly" through security entitlements with affiliated bank custodians or with the securities depositories that generally hold the underlying certificates. Similarly, implementation of signed notations in connection with withdrawals, deposits and transfers through banks or securities depositories may not be practicable.

We believe that the appropriate means of providing additional safeguards for the use of affiliated custodians is to establish specific requirements for such use as a separate regulation, rather than to subject such arrangements to Rule 17f-2. Indeed, such an approach seems exactly what was contemplated by Congress when, as part of the Gramm-Leach-Bliley Act, [65] it amended Section 17(f) to add a new paragraph (6). New subsection 17(f)(6) provides that:

"the Commission may, after consultation with and taking into consideration the views of the Federal banking agencies …, adopt rules and regulations and issue orders, consistent with the protection of investors, prescribing the conditions under which a bank, or an affiliated person of a bank, either of which is an affiliated person, promoter, organizer, or sponsor of, or principal underwriter for, a registered management company, may serve as custodian of that registered management company."

We recommend that the Commission accept the invitation of Congress in Section 17(f)(6) with respect to affiliated bank custodians. At the same time, the Commission should clarify that Rule 17f-2 will not apply to the use of any type of affiliated custodian. [66]

Also, in fashioning a special rule for the use of affiliated custodians, we believe that the Commission should clarify which types of relationships between a fund and its custodian should constitute an affiliation sufficient to trigger the rule. Currently, this is not sufficiently clear. Examples of custody arrangements whose treatment is uncertain under existing staff interpretations include the use of a custodian that is affiliated with the fund's adviser through common directors, officers or employees but not through common control, [67] or the use of certain foreign custody arrangements involving remote affiliates, and the extent to which the use of affiliated sub-custodians is covered when there is an unaffiliated primary custodian. [68]

E. Amend the Fidelity Bonding Rule (Rule 17g-1)

Rule 17g-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 amount of the bond required, based on each individual investment company's gross assets. The current schedule, as applied to fund complexes that obtain joint insured bonds, results in a required amount of coverage greatly exceeding what is reasonably necessary, at a significant cost to shareholders. In 1996, the Institute submitted a letter to the SEC staff recommending that the Commission amend Rule 17g-1 to address this problem, and to improve the rule in certain other respects, as discussed below. [69] We urge the Commission to move forward on the Institute's proposal.

First, to provide for a more appropriate required amount of coverage, the rule should establish minimum coverage requirements for a fund complex, rather than for individual funds. The rule also should set a cap on the amount of required fidelity bond coverage for a joint insured bond that names as insured members of the same fund complex. As discussed in the 1996 Letter, based on the growth of fund complexes and fund assets since Rule 17g-1 was last amended, the fund industry's loss history, and the much lower minimum coverage requirements applicable to other regulated industries, the Institute recommends a cap of $100 million. [70]

In addition to these changes, the Commission should amend Rule 17g-1 to require that fidelity bonds be issued on an "each and every occurrence" basis, so that a bond would continue in force up to the full limits of liability for each single loss. The rule also should be revised to clarify that all entities within a fund complex that are primarily engaged in providing investment management or investment advice (including ancillary services) may be named on the same joint bond.

As we suggested previously, the Commission should eliminate the current requirement that the independent directors approve the portion of any premium to be paid by an investment company, after considering various factors. Instead, in connection with the initial and annual approval of a joint bond, directors should be required to consider all relevant factors, which would include the portion of the premium to be paid by a fund, among other factors. We also recommend that the rule be revised to simplify and modernize its filing and notification procedures.

F. Allow Interval Funds to Use Distribution Financing Arrangements (Rule 23c-3)

Rule 23c-3 under the Investment Company Act permits closed-end funds to repurchase shares on a periodic basis. In 1993, when the Commission adopted the rule, it considered, but did not adopt, rule provisions to permit such funds (referred to as "interval funds) to impose contingent deferred sales loads (CDSLs) and/or asset-based sales charges (ABSCs). Instead, in the release adopting the rule, the Commission stated that it may be appropriate to consider amending Rule 23c-3 to permit such charges after it considers "whether to adopt proposed rule 6c-10, which would permit the imposition of CDSLs by open-end companies, and has the opportunity to monitor the effects of the NASD sales charge rule upon distribution charges of open-end companies." [71] Given that the Commission now has had significant experience with these rules, the Institute recommends that Rule 23c-3 be amended for this purpose. [72] There does not appear to be any policy justification for prohibiting interval funds from imposing a CDSL or ABSC. Indeed, the Commission has granted numerous exemptive orders permitting interval funds to use such distribution financing arrangements. [73] Moreover, the Commission has recognized the similarities between the financing of the distribution of interval fund shares and open-end fund shares. [74]

Consistent with the relief granted by the Commission in this area, any interval fund that adopts either of these financing arrangements should be required to: (a) fully disclose the arrangement in its prospectus; (b) in the case of CDSLs, comply with the provisions of Rule 6c-10 under the Act; and (c) in the case of ABSCs, comply with the provisions of Rules 12b-1 and 17d-3 under the Act. [75]

Below, the Institute has furnished proposed amendments to Rule 23c-3 to implement our recommendations.

Proposed Amendments to Rule 23c-3
New language in bold; deleted language underlined and in brackets

1. Amend paragraph (b)(1) to read as follows:

"(b)(1) The company shall repurchase the stock for cash at the net asset value determined on the repurchase pricing date and shall pay the holders of the stock by the repurchase payment deadline except as provided in paragraph (b)(3) of this section. The company may deduct from the repurchase proceeds only (a) a repurchase fee, not to exceed two percent of the proceeds, that is paid to the company and is reasonably intended to compensate the company for expenses directly related to the repurchase and (b) a deferred sales load, provided that it complies as if the company were an open-end company with the conditions set forth in § 270.6c-10."

2. Amend paragraph (b) to add new subparagraph (12), to reads as follows:

"(12) The company may engage directly or indirectly in financing any activity which is primarily intended to result in the sale of shares issued by such company, provided that it complies as if the company were an open-end company with the conditions set forth in § 270.12b-1 and § 270.17d-3."

G. Eliminate Unnecessary Voting Requirements

In its 1995 Submission, the Institute recommended that the Commission undertake rulemaking to eliminate certain shareholder voting requirements under the Investment Company Act that do not address any important investor protection concerns. As discussed below, the Institute again urges the Commission to eliminate the need for a shareholder vote (1) with respect to any change in a policy involving "security-based loans," or (2) if a fund decreases the "concentration" of its portfolio in a particular industry or group of industries. [76]

Section 8(b) of the Investment Company Act requires investment companies to include in their registration statements a recital of their policies with respect to "making loans to other persons." Section 13(a)(2) provides that no registered investment company may, without a shareholders' vote, "make loans to other persons" except according to the recital of its policies in the registration statement. Section 2(a)(23) of the Investment Company Act defines "lend" to include "a purchase coupled with an agreement by the vendor to repurchase…." The SEC staff previously has indicated that the recitation of policy must encompass "the company's use of repurchase agreements, the lending of portfolio securities, and the purchase of privately-offered debt securities." [77]

In the 1992 Study, the Division recommended the exclusion of these "security-based loans" from Sections 8(a) and 13(a)(2) because their inclusion "ignores the realities of modern securities markets." [78] As the Division reasoned, repurchase agreements are commonly used by investment companies to manage their cash over a short term, securities are commonly loaned on a short term basis to increase income, and investment companies routinely purchase privately-offered debt securities. The Division also concluded that "these transactions generally have no more than a modest effect on an investment company's overall risk or return." [79]

In the 1992 Study, the Division also recommended several measures to eliminate the requirement for a shareholder vote when an investment company decreases the "concentration" of its portfolio in a particular industry or group of industries. Section 8(b) of the Investment Company Act requires that registration statements recite the investment company's policy concerning "concentrating investments in a particular industry or group of industries…." Section 8(b) also requires that the recital of policy state "whether the registrant reserves freedom of action to engage in activities of such type, and if such freedom of action is reserved, a statement briefly indicating, insofar as is practicable, the extent to which the registrant intends to engage therein…." Section 13(a) of the Investment Company Act provides that no investment company, may, without a shareholder vote, "deviate from its policy in respect of concentration of investments in any particular industry or group of industries as recited in its registration statement."

As noted in the 1992 Study as well as our 1995 Submission, the practical effect of the Division's interpretation of Section 8(b) is that an investment company that states in its registration statement that it will concentrate in an industry or industry group typically must obtain shareholder approval before the investment adviser may diversify the shareholders' risk by reducing its portfolio concentration below the twenty-five percent level. As discussed in the 1992 Study, this result "may prevent an investment company's adviser from reallocating portfolio assets among industries in a way that best reflects its analysis of current market conditions, even if such action would pose little or no risk to shareholders." [80]

The Institute agrees with the analysis and conclusions in the 1992 Study, which make clear the need to update the current shareholder voting requirements as they relate to "security-based loans" and decreasing portfolio concentration. We therefore continue to recommend that Commission eliminate the need for shareholder votes with respect to these matters.

IV. Recommendations Concerning Variable Insurance Products

The Institute recommends the adoption of new rules under the Investment Company Act that would codify, or eliminate the need for, exemptive relief with respect to open-end management investment companies that underlie variable annuity contracts and variable life insurance contracts (such investment companies are referred to herein as "underlying funds" and such contracts are referred to as "Variable Contracts). In particular, new rules are recommended for the two types of relief that are sought most frequently—mixed and shared funding and substitutions.

A. Amend Rules to Allow Mixed and Shared Funding

Two rules under the Investment Company Act currently provide exemptive relief from various provisions of the Act to separate accounts funding variable life insurance (VLI) contracts to permit those contracts to be offered and administered under the Act. First, Rule 6e-2 provides exemptive relief for scheduled premium VLI contracts. However, where the separate accounts funding these contracts are organized as unit investment trusts, [81] certain relief provided by Rule 6e-2 is available only if shares of the underlying fund are offered "exclusively" to separate accounts funding VLI contracts of the insurance company or of any affiliated life insurance company. [82] Because of this exclusivity requirement, to qualify for exemptive relief under the rule, the underlying fund cannot offer its shares to: (1) separate accounts funding variable annuity (VA) contracts of the same or an affiliated insurer (mixed funding); (2) separate accounts funding VLI contracts of unaffiliated insurers or separate accounts funding VA contracts of unaffiliated insurers (shared funding); (3) qualified pension plans; (4) the underlying fund's investment adviser or its affiliates; or (5) the insurer.

Second, Rule 6e-3(T) under the Investment Company Act provides relief from various provisions of the Act to separate accounts funding flexible premium VLI contracts. However, where the separate accounts funding flexible premium VLI contracts are organized as unit investment trusts, certain relief provided by Rule 6e-3(T) is available only if shares of an underlying fund are offered "exclusively" to: (1) separate accounts of the same or affiliated insurance companies, offering either scheduled premium and/or flexible premium VLI contracts; (2) separate accounts funding VA contracts of the same insurer or an affiliated insurer, subject to certain conditions; and (3) the life insurer or any affiliated life company, subject to certain conditions, in consideration solely for advances made by the life insurer in connection with the operation of the separate account. [83] Thus, Rule 6e-3(T) permits "mixed funding," but exemptive relief is required if an underlying fund that relies on the rule also offers its shares to: (1) separate accounts funding VLI contracts or separate accounts funding VA contracts of unaffiliated insurers; (2) qualified pension plans; or (3) the underlying fund's investment adviser or its affiliates.

The Commission has never fully articulated the reason for the "exclusivity" requirement in Rule 6e-2 and the adopting release for Rule 6e-2 is silent on this point. [84] The release adopting Rule 6e-3(T) states that the Commission prohibited mixed funding in Rule 6e-2 "based in part on concerns that conflicts could arise between the interests of variable life and variable annuity contractholders" (emphasis added). [85] However, this statement does not purport to explain all of the Commission's reasoning for the exclusivity requirement and does not explain why the Commission chose to prohibit shared funding. Comment letters on proposed Rule 6e-3(T) suggested that the Commission permit shared funding, and, the Commission in a later release adopting amendments to Rule 6e-3(T), noted that:

The Commission has granted several exemptive orders to allow applicants to participate in shared funding arrangements. However, this is a very new and somewhat complicated area from a regulatory perspective. Too few applications have been received to have raised and explored all of the issues inherent in these arrangements. For example, there are a number of issues concerning voting arrangements in this area. Therefore, the Commission has decided not to address shared funding arrangements in the rule at this time, but expects to deal with this by rule after more applications experience. [86]

Since the adoption of Rules 6e-2 and 6e-3(T), the Commission has granted over 140 exemptive orders permitting mixed and shared funding. [87] Typically, these exemptive orders permit underlying funds to be offered to separate accounts funding VA contracts and VLI contracts of affiliated and unaffiliated insurers, and in more recent orders, to qualified plans and to an underlying fund's investment adviser and its affiliates. [88]

These exemptive orders impose an elaborate set of conditions upon underlying funds, their advisers, and participating insurers to monitor for the existence of "material irreconcilable conflicts." These include, among other things, the following requirements:

- The board of the underlying fund must monitor for the existence of any material irreconcilable conflict among the interests of various Variable Contract owners investing in the fund, and the board must determine what action, if any, should be taken in response to such conflicts;
- Participating insurers, the fund adviser, and pension plans investing in an underlying fund must monitor for material irreconcilable conflicts and report any such conflicts to the underlying fund's board of directors;
- In the event of a material irreconcilable conflict, participating insurers must agree to any actions that the fund's board determines to take to resolve the conflict; [89] and
- If a pension plan invests in an underlying fund, it must agree to any actions that the fund's board determines to take to resolve a

conflict, and the plan must agree in writing to this and other requirements.

The Institute questions the appropriateness and need for these conditions. First, while applications for mixed and shared funding relief typically recite sources of potential conflicts, [90] we are not aware of situations where these conflicts have arisen.[91] Moreover, we question whether these conflicts are more likely to arise in connection with underlying funds than other types of open-end management investment companies. Second, the requirement that pension plans monitor for conflicts and agree in advance to measures to resolve conflicts, which could include a forced redemption, do not apply to a pension plan's investment in other types of open-end management investment companies. This places underlying funds at a competitive disadvantage in competing for assets from pension plans. Finally, as a condition of mixed and shared funding orders, the Commission has required that participating insurers and fund managers investing their own assets in an underlying fund must give up their voting rights in their shares. Voting is a fundamental property right accompanying ownership in equity securities. The Commission, however, has never provided an explanation as to why insurers and fund managers must relinquish their voting rights.

Thus, in light of the unclear purposes of the exclusivity requirements in Rules 6e-2 and 6e-3(T), the extensive experience of the Commission staff with processing mixed and shared funding exemptive orders, and the questions regarding the necessity of the conditions for mixed and shared funding relief, the Institute recommends that Rules 6e-2 and 6e-3(T) be amended to eliminate the "exclusivity" requirements.

Below, the Institute has furnished proposed rule amendments to implement the Institute's recommendations.

Proposed Rule Amendments to Permit Mixed and Shared Funding
New language in bold, deleted language underlined and in brackets

1. Amend paragraph (b) of Rule 6e-2 to read as follows:

(b) * * *

(15) If the separate account is organized as a unit investment trust, all the assets of which consist of the shares of one or more registered management investment companies which offer their shares exclusively to variable life insurance separate accounts of the life insurer or of any affiliated life insurance company …

2. Amend paragraph (b) of Rule 6e-3(T) to read as follows:

(b) * * *

(15) If the separate account is organized as a unit investment trust, all the assets of which consist of the shares of one or more registered management investment companies which offer their shares exclusively to variable life insurance separate accounts of the life insurer, or of any affiliated life insurance company… offering either scheduled contracts or flexible contracts, or both; or which also offer their shares to variable annuity separate accounts of the life insurer or of an affiliated life insurance company, or which offer their shares to any such life insurance company in consideration solely for advances made by the life insurer in connection with the operation of the separate account; Provided, That: the board of directors of each investment company, constituted with a majority of disinterested directors, will monitor such company for the existence of any material irreconcilable conflict between the interests of variable annuity contract holders and scheduled or flexible contract holders investing in such company; the life insurer agrees that it will be responsible for reporting any potential or existing conflicts to the directors; and if a conflict arises, the life insurer will, at its own cost, remedy such conflict up to and including establishing a new registered management investment company and segregating the assets underlying the variable annuity contracts and the scheduled or flexible contracts; Then:

* * *

B. Adopt Rules to Allow Substitutions of Insurance Product Funds

The Institute recommends that the Commission adopt a new rule under the Investment Company Act to permit insurance companies and their registered separate accounts to substitute shares of one underlying fund for another without first obtaining Commission approval under Section 26(c) of the Act. [92] In addition, the Institute recommends that the Commission adopt a companion rule to the new rule on substitutions to permit the transfer in-kind of portfolio securities from an existing underlying fund to a new underlying fund in effecting a substitution. Relief is often sought for this type of transaction in applications seeking approval for substitutions as it would be prohibited or restricted under Commission staff interpretations of Section 17(a) of the Investment Company Act.

1. Rule 26c-

Section 26(c) of the Investment Company Act requires the depositor or trustee of a registered unit investment trust holding the securities of a single issuer to obtain approval from the Commission before substituting other securities for the securities held by the trust. Section 26(c) was added to the Act by the Investment Company Act Amendments of 1970 [93] due to concern over high sales charges on unit investment trusts and the effect on investors who did not want to remain in the substituted portfolio.

Variable Contracts, however, are very different from traditional unit investment trusts. In a traditional unit investment trust, substitution of an investment security would affect all the investors in the trust for the duration of the trust. By contrast, Variable Contracts generally provide contract owners with a choice of underlying funds and transfers among underlying fund options are not subject to a sales load. Thus, substitutions by insurance company separate accounts do not present the type of concerns that Section 26(c) was intended to address. Nonetheless, insurers seeking a substitution must apply for approval under Section 26(c) on a case-by-case basis.

Since the early 1980's, the staff has issued numerous exemptive orders to permit substitutions by insurers, including over fifty in the last three years. [94] The standards that have been applied by the staff in reviewing applications for substitutions have evolved. Since the early 1980's, the staff has reviewed the expenses paid by shareholders, and, through much of this period, granted relief where the expenses of a new underlying fund were no higher than those of an existing underlying fund. [95] In recent years, facts underlying many substitutions have become more complex and, as a result, the standards applied by the staff continue to evolve. These standards have been described by the Director of the Division of Investment Management as follows:

We look carefully at each application to determine the overall impact the substitution will have on contract owners. Perhaps, the most immediately apparent impact arises from changes in expense levels. When a substitution results in higher overall expenses, we may condition exemptive relief on a cap at the level of the replaced fund's expense ratio for some period of time.

But be assured that we look at more than overall expense ratios. We compare, for example, the investment objectives and policies of the substitute and replaced funds, and we consider the existence and nature of any affiliation between the insurance company and the affected funds, as well as whether or not Rule 12b-1 or revenue sharing arrangements are in place. We are focusing in particular on situations where the new substitute fund has higher advisory fees or 12b-1 fees that, absent a substitution, could not be imposed without a shareholder vote—and we are in some cases requiring shareholder votes for those types of transactions. [96]

Insurers may wish to substitute a new underlying fund for an existing underlying fund for many reasons including, among others: the existing fund may intend to cease operations; the insurer may be concerned that an existing fund is too small to be viable; or the existing fund may not have performance that is satisfactory. The required application process, however, results in significant costs for insurers and/or fund managers and attendant delays. Under some circumstances, such as where an existing fund is small or intends to cease operations, these delays can be harmful to investors. [97]

The staff also has issued no-action letters permitting substitutions in the context of underlying fund reorganizations, mergers and liquidations. For example, in a recent no-action letter, the staff permitted an insurer to allocate proceeds it received on a contract owner's behalf upon the liquidation of an underlying fund, where the insurer had not yet received transfer or allocation instructions from the contract owner, to an underlying money market fund, without first obtaining Commission approval under Section 26(c) of the Act. [98] The staff based its decision, in part, on the fact that "money market funds generally are regarded as suitable short-term cash management vehicles." [99]

To permit substitutions without the delays accompanying the exemptive application or no-action letter processes, the Institute recommends that the Commission adopt a new rule under the Investment Company Act to permit insurance companies and their registered separate accounts to substitute shares of one underlying fund for another without first obtaining Commission approval under Section 26(c) of the Act. The new rule would exempt insurance company depositors from Section 26(c) based on a set of conditions that would capture the most important of the criteria that have been employed by the staff in reviewing applications: (1) the compatibility of investment objectives and strategies; and (2) expenses.

The new rule also would permit money market funds to serve as a "default" investment for substitutions. It is our understanding that the staff currently limits a substitution into a money market fund to situations involving a reorganization, merger or liquidation.[100] We recommend that the new rule not be similarly limited but rather permit such a substitution regardless of the event triggering the substitution. Given that the condition in the new rule relating to notice to variable contract owners would ensure that they are alerted to the opportunity to reallocate and the conditions relating to expenses would ensure that the expenses of the money market fund were no higher than those of the existing fund, the interests of investors will be adequately protected while invested in the money market fund. The triggering event itself therefore should not be relevant.

The recommended rule would leave for Commission approval on a case-by-case basis those substitutions that do not meet these conditions.[101]

2. Rule 17a-

If an insurance company separate account owns five percent or more of the outstanding voting shares of an underlying fund, the separate account and its insurance company depositor may be deemed to be affiliated persons of the fund. In addition, an existing underlying fund and an underlying fund that will replace that fund in a substitution may be affiliated persons of each other if they share the same adviser, officers, or directors. Therefore, if an existing fund underlying a Variable Contract is to be replaced with another fund that underlies the same Variable Contract, and an insurer's separate account or accounts hold more than five percent of each of the funds, the two funds may be affiliated persons of affiliated persons.

In this case, an underlying fund redeeming in-kind its shares held by the insurance company separate account and the separate account using the redemption proceeds to purchase securities issued by the new underlying fund (collectively, In-Kind Transactions), could be construed as the purchase and sale of securities by an affiliated person of an affiliated person of a registered investment company. Absent relief provided by rule, insurers and underlying funds must apply for an exemptive order or must rely on prior no-action guidance.

The staff has provided no-action relief allowing certain In-Kind Transactions that would otherwise be prohibited under Section 17(a). For example, the staff has stated that a registered investment company may make redemptions in-kind under certain circumstances that are consistent with the purposes of Section 17(a), without the need to obtain an exemptive order under Section 17(b).[102] In addition, numerous exemptive orders have been issued permitting redemptions and purchases in kind between insurers and affiliated underlying funds, under certain conditions, in connection with substitution transactions.[103] Among the conditions to which Section 17(b) applicants have agreed is that the In-Kind Transaction will comply or will substantially comply with the conditions in Rule 17a-7.[104] These conditions provide safeguards to ensure that the terms of an In-Kind Transaction in a substitution transaction involving registered investment companies and affiliated persons are fair and reasonable, and that the transactions do not involve overreaching on the part of any person involved in the transaction.[105]

The staff's willingness to grant relief in numerous applications relating to Section 17(a) demonstrates its recognition that, with respect to In-Kind Transactions in the context of separate account substitutions, adequate safeguards are in place to assure that the potential abuses that Section 17(a) was designed to address will not occur. The Institute therefore recommends that the Commission adopt a companion rule to the new rule on substitutions to permit substitutions to be effected, in whole or in part, by transferring securities in-kind from an existing underlying fund to a new underlying fund. Generally, the proposed rule would codify the positions taken by the Division in no-action letters and several exemptive orders.

Below, the Institute has furnished proposed rules to implement these recommendations.

Rule 26c - Exemption from Section 26(c) for Certain Substitutions of Securities
A depositor of a registered separate account that is classified as a unit investment trust shall be exempt from the requirement of Section 26(c) of the Act that the Commission shall have approved the substitution of securities of a single issuer if the single issuer whose securities are held by the separate account or a sub-account thereof (separate account) is a registered open-end management investment company or a series thereof (existing portfolio company) and the securities to be substituted are shares of a registered open-end management investment company or a series thereof (new portfolio company); provided that:

(a) (i) The depositor has determined that the investment objectives and strategies of the new portfolio company are compatible with or similar to those of the existing portfolio company; or

(ii) The new portfolio company holds itself out to investors as a money market fund or the equivalent of a money market fund;

(b) At the time of the substitution, the expense ratio of the new portfolio company, after any expense reimbursement or fee waiver arrangement, is equal to or less than the expense ratio of the existing portfolio company, after any expense reimbursement or fee waiver arrangement; and any such expense reimbursement or fee waiver arrangement with respect to the new portfolio company shall be in effect for at least a one year period from the date of the substitution;

(c) Owners of variable annuity contracts or variable life insurance contracts participating in the separate account (such contracts referred to as "variable contracts" and such owners referred to as "variable contract owners) will not bear any expenses or incur any fees or charges in connection with or as a result of the substitution, including any brokerage costs, and the substitution will not alter the contractual benefits of such owners or the obligations of the depositor under such contracts;

(d) The depositor believes that the substitution will not alter the tax treatment of the variable contracts;

(e) The substitution will be effected at the relative net asset values of the shares of the existing portfolio company and new portfolio company;

(f) The substitution shall not be considered a transfer for purposes of any limitations or charges on transfers among separate accounts available under the variable contracts, and, for a period starting from the date the notice of the substitution specified under condition (g) below is sent to variable contract owners to 30 days after the substitution, the depositor shall allow a transfer from the separate account that shall not be subject to any limitations or charges on transfers applicable to the variable contracts;

(g) At least 30 days prior to the substitution, the depositor shall send written notice to variable contract owners that shall describe the substitution, including the substance of conditions (b), (c), and (f) above; and such notice shall be filed with the Commission as a part of or a supplement to the prospectus included in the registration statement for the separate account; and

(h) Within 5 business days after the substitution is effected, the depositor shall send to variable contract owners a written notice that the substitution was carried out and that describes the right of such owners to make a transfer as provided in condition (f) above.

Rule 17a - Exemption of Certain Transactions in Separate Account Substitutions

A redemption of shares of a registered open-end management investment company or a series thereof (existing portfolio company) made in assets other than cash (assets) by a registered separate account that is classified as a unit investment trust or a sub-account thereof (separate account), and the purchase by such separate account with such assets of shares of a registered open-end management investment company or a series thereof (new portfolio company), which redemption and purchase occur in connection with a substitution of the shares of the new portfolio company for shares of the existing portfolio company by such separate account pursuant to Rule 26c-__ of the Act, is exempt from Section 17(a) of the Act; provided, that:

(a) Such redemption and purchase transactions are effected on the basis of the independent current market price of such assets, which shall be determined as provided in paragraph (b) of Rule 17a-7 or in a manner that conforms substantially to the provisions of Rule 17a-7 with respect to the independence of the determination of the prices of such assets and consistent with Section 2(a)(41) of the Act and Rule 2a-4 thereunder;

(b) The redemption and purchase are consistent with the investment objectives and strategies of each of the existing portfolio company and the new portfolio company, as recited in its registration statement and reports filed under the Act;

(c) No brokerage commission, fee (except for customary transfer fees), or other remuneration is paid in connection with the redemption and purchase transactions;

(d) The board of directors of the existing portfolio company, including a majority of the directors who are not interested persons of such company:

(1) Determines that the redemption in such assets is fair and reasonable to all shareholders of the company;

(2) Determines that assets tendered upon redemption are, or the manner for selecting such assets is, fair and reasonable to all shareholders of the company;

(3) Determines that the independent current market price of such assets or the manner for determining such independent current market price meets the requirements provided in paragraph (a) of this rule; and

(4) Reviews the completed transaction and determines that the redemption has been effected in compliance with the provisions of paragraphs (d)(1)(2), and (3) of this rule; and

(e) The board of directors of the new portfolio company, including a majority of the directors who are not interested persons of such company:

(1) Determines that the issuance of shares in exchange for such assets is fair and reasonable to all shareholders of the company;

(2) Determines that assets received upon such purchase are fair and reasonable to all shareholders of the company;

(3) Determines that the independent current market price of such assets or the manner for determining such independent current market price meets the requirements provided in paragraph (a) of this rule; and

(4) Reviews the completed transaction and determines that the purchase has been effected in compliance with the provisions of paragraphs (e)(1)(2), and (3) of this rule; and

(f) The determinations made in paragraph (d) of this rule, and the basis upon which the determinations were made, are recorded in the minute book of the existing portfolio company;

(g) The determinations made in paragraph (e) of this rule, and the basis upon which the determinations were made, are recorded in the minute book of the new portfolio company;

(h) A majority of the directors of each of the existing portfolio company and the new portfolio company are not interested persons of the company, and those directors select and nominate any other disinterested directors of the company; and any person who acts as legal counsel for the disinterested directors of the company, other than a person who provides services as a special counsel,[106] is an independent legal counsel; and

(i) Each of the existing portfolio company and the new portfolio company maintains and preserves for a period not less than six years from the end of the fiscal year in which the redemption and purchase occurred, the first two years in an easily accessible place, a written record of such redemption and purchase, the terms of such redemption and purchase, and the information or materials upon which the determinations described in paragraphs (d) or (e) of this rule, as applicable, were made.

V. Other Regulatory Recommendations

A. Reduce the Frequency of Filing Reports on Form 13F

Section 13(f) of the Exchange Act generally requires institutional investment managers, including mutual fund managers, to file reports with the Commission in accordance with Commission rules if they manage, in the aggregate, more than $100 million in certain equity securities. Pursuant to Rule 13f-1, any institutional investment manager that exercises investment discretion with respect to accounts holding “Section 13(f) securities” with an aggregate fair market value on the last trading day of any month of any calendar year of at least $100,000,000 must file a report on Form 13F (13F Report) with the Commission within 45 days after the last day of such calendar year and within 45 days after the last day of each of the first three calendar quarters of the subsequent calendar year.[107] For the reasons stated below, 13F Reports are not serving one of their primary purposes; instead, they are being used for purposes not contemplated by Congress and in a manner that is directly contrary to the protection of investors. The Institute recommends that the Commission reduce the frequency of the 13F filing requirements from quarterly to semi-annually to better ensure that 13F Reports are used to achieve their designated objectives without promoting activities that negatively impact investors. We also recommend that the Commission require that the reports be filed within 60 days after the end of the relevant period.

In July 1968, Congress directed the Commission to study and investigate the purchase, sale, and holding of securities by institutional investors of all types to determine the effect of those activities on the maintenance of fair and orderly securities markets and the interests of issuers of securities and of the public.[108] In its letter transmitting the Institutional Investor Study Report[109] to Congress in April 1971, the Commission cited “gaps in information about the purchase, sale and holdings of securities by major classes of institutional investors,” and recommended that the 1934 Act be amended to provide the Commission with the authority to require periodic reports and disclosure of securities holdings and transactions from various types of institutional investors. Other recommendations for improved disclosure and reporting were made by the President’s Commission on Financial Structure and Regulation (1971) and by the Senate Subcommittee on Securities in the 1973 “Securities Industry Study.”[110]

Thereafter, Congress adopted Section 13(f) of the Exchange Act as part of the Securities Act Amendments of 1975. One of the primary purposes behind Section 13(f) when it was enacted was to create at the Commission a central repository of information about the investment activities of institutional investment managers in order to allow regulatory agencies to analyze the influence and impact of those managers on the securities markets as well as the public policy implications of their investment activities.[111] Congress also indicated that by making the Commission responsible for all gathering, processing, and dissemination of the data, Congress intended to permit the establishment of uniform reporting standards and a uniform centralized data base.[112] Since the enactment of Section 13(f), however, there is no evidence that the Commission has made extensive use of this information for any purpose. In addition, while Section 13(f) also was intended to provide greater public disclosure of institutional holdings, Congress could not possibly have anticipated the technological advances that have greatly increased the speed and ease with which the information in 13F Reports may be accessed and disseminated.

While there is no evidence that the information is being used as intended, there is evidence that it is being used for purposes that were not contemplated by Congress and that are harmful to mutual fund shareholders. For example, as discussed in a July 2001 Institute letter to the SEC staff, the requirement that managers file 13F Reports on a quarterly basis likely promotes trading activities that hurt fund shareholders.[113] Indeed, commercial services that offer the ability to trade securities on the basis of information regarding the holdings of mutual funds and institutional money managers rely in significant part on information from 13F Reports. The ready availability of 13F Reports has allowed such services to package this information in a way that facilitates predatory securities trading practices that are harmful to mutual fund shareholders, such as front-running mutual fund trades and free riding on funds’ investment research.[114]

Not only would a change in the frequency of filing 13F Reports from quarterly to semi-annually minimize concerns that the information may be used in ways that negatively impact mutual fund shareholders, but also a semi-annual requirement would be entirely consistent with the purposes, and the specific provisions, of Section 13(f).[115] When the Commission first proposed Rule 13f-1 in March 1977, it solicited comments on the frequency of the reporting intervals under the proposed rule.[116] After receiving over 70 letters of comment on the rule proposal, most commentators were in favor of annual rather than quarterly reporting, particularly since quarterly reporting would be overly burdensome and costly.[117]

Accordingly, the rule as adopted in 1978 included an annual reporting requirement. The Adopting Release indicated, however, that the Commission had recently received several letters supporting a quarterly reporting requirement. Noting that, among other things, the initial proposal involved a different and more complex form, the Commission issued a second request for comment on the appropriate frequency of reporting. Following this second round of comments, the Commission concluded that quarterly reporting was in the public interest "at this time," because it did not "perceive any significant obstacles to quarterly reporting nor any undue hardship for reporting institutions."[118] The Commission also expressed a concern that "if quarterly reporting is not required at this time, the data might be lost altogether thereby creating gaps in the continuous flow of information which may be utilized for future policy decisions."[119]

In the more than twenty years since the quarterly reporting requirement was adopted, we are not aware of any use of the quarterly data in 13F Reports either as a basis for policy decisions or for any other governmental purposes. On the other hand, it is clear that the data are being used to benefit persons other than those originally intended. To minimize the abuses resulting from the availability of information contained in quarterly 13F Reports, such as front running and free riding, the Commission should require semi-annual, rather than quarterly, reporting of this information.

To provide additional protection against abusive uses of the information contained in 13F Reports, we further recommend that the Commission require the filing of such reports within 60 days after the end of the relevant period, instead of 45 days. The current 45-day period was selected because it is consistent with the timing of filing reports on Schedule 13G and parts of Form 13F may be used to satisfy requirements of Schedule 13G.[120] Requiring the filing of 13F Reports within 60 days after the end of the period would not preclude investment managers from filing earlier if they wished to take advantage of this ability. It would, however, provide flexibility to those managers who believe their 13F Reports may invite abusive practices. As indicated in a study discussed in the Institute's July 2001 Letter, "the combination of a six-month reporting period and a 60-day reporting lag . . . reduce the potential returns outsiders can garner from mimicking the reported portfolio."[121]

Rule language to implement our recommendations is set forth below.

Proposed Amendments to Rule 13f-1 to Revise Frequency of Filing Reports
New language in bold; deleted language underlined and in brackets

Amend paragraph (a)(1), to read as follows:

"(a)(1) Every institutional investment manager which exercises investment discretion with respect to accounts holding section 13(f) securities, as defined in paragraph (3) of this section, having an aggregate fair market value on the last trading day of any month of any calendar year of at least $100,000,000 shall file a report on Form 13F § 249.325 of this Chapter with the Commission within 60 45 days after the last day of such calendar year and within 60 45 days after the last day of the second calendar quarter each of the first three calendar quarters of the subsequent calendar year."

B. Revise the Staff's Position Concerning the Liquidity of Section 4(2) Commercial Paper

Mutual funds generally may not invest more than 15 percent of their net assets in illiquid securities (10 percent for money market funds).[122] The Commission and the staff have indicated that certain types of securities, including securities that are restricted as to resale, should be presumed to be illiquid. One such example involves commercial paper issued in reliance on Section 4(2) of the Securities Act (4(2) Paper).[123] The staff has allowed fund boards to determine that 4(2) Paper is, in fact, liquid.[124] Fund boards are permitted to delegate the responsibility to assess and monitor the liquidity of 4(2) Paper to the fund's adviser, subject to board oversight.[125]

Some funds have established board-approved criteria for making liquidity determinations concerning 4(2) Paper and other presumptively illiquid securities, and they periodically report to the board concerning these determinations. While this process is not particularly burdensome, it is essentially meaningless with respect to 4(2) Paper, for the reasons discussed below. The Institute recommends that the staff eliminate the need for a pointless ritual that takes up board time that could be spent more productively on other, more important matters. Specifically, we suggest that the staff issue interpretive guidance indicating that 4(2) Paper is presumptively liquid.

Unlike 4(2) Paper, commercial paper issued in reliance on Section 3(a)(3) under the Securities Act (3(a)(3) Paper) is presumed to be liquid. In fact, however, 4(2) Paper, like 3(a)(3) Paper, is highly liquid, and, therefore, there is no justification for their disparate treatment.[126] Both 3(a)(3) Paper and 4(2) Paper are purchased by large financial institutions, many of which are money market funds, and 4(2) Paper is virtually identical to 3(a)(3) Paper in all other relevant respects.[127] For example, like 3(a)(3) Paper, 4(2) Paper issues range in various maturities up to 9 months, and the paper is high quality, is discountable by Federal Reserve Banks and generally is not purchased by the general public. 4(2) Paper trades in the same market and in the same manner as 3(a)(3) Paper. Notwithstanding its restricted status, a secondary market for 4(2) Paper has developed that possesses the same degree of liquidity as that for 3(a)(3) Paper. The interest rates, maturity dates and secondary market bids and asks are identical for 3(a)(3)

Paper and 4(2) Paper. 4(2) Paper serves the same function as 3(a)(3) Paper, which is to satisfy the short-term financing requirements of large issuers. Rating agencies treat 3(a)(3) Paper and 4(2) Paper in the same manner.[128] The Federal Reserve Banks treat 3(a)(3) Paper and 4(2) Paper identically.[129]

Nevertheless, unlike 4(2) Paper, 3(a)(3) Paper is presumed to be liquid because it may be sold and resold to the public without registration, even though, like 4(2) Paper, 3(a)(3) Paper is sold to a relatively small number of large institutional buyers in transactions that would qualify for a private placement. Accordingly, the disparate legal treatment of 3(a)(3) Paper and 4(2) Paper is not in keeping with marketplace reality. Because 4(2) Paper is, in fact, as liquid as 3(a)(3) Paper, it is appropriate also to presume that 4(2) Paper is liquid and the conditions imposed in Merrill Lynch are not necessary.

Thus, we urge the staff to update its position concerning the liquidity of 4(2) Paper.[130] Allowing funds to treat 4(2) Paper as presumptively liquid would better reflect market reality and would help eliminate situations where directors are asked to "conduct reviews . . . that involve more ritual than substance . . . ."[131]

C. Amend Investment Adviser Advertising and Custody Rules

1. Background

Section 206(4) of the Investment Advisers Act of 1940 provides that it is unlawful for any investment adviser to engage in any act, practice or course of business that is fraudulent, deceptive, or manipulative. This provision of the Act authorizes the Commission, by rules and regulations, to define and prescribe means reasonably designed to prevent any such fraudulent, deceptive, or manipulative acts, practices, or courses of business. In 1962, the Commission, pursuant to the authority granted to it under Section 206(4), adopted Rule 206(4)-1 (relating to advertisements by investment advisers), and Rule 206(4)-2 (relating to custody or possession of funds or securities of clients), each of which we believe has become woefully outdated and unduly restrictive. As a result, these rules today prohibit conduct that is not fraudulent, deceitful, or injurious to investors. To address our concerns with these two rules, in 1998 the Institute submitted to the Division of Investment Management proposed rule amendments that would update and modernize these rules while continuing to protect investors from fraudulent or deceitful conduct.[132] We urge the Commission to act on these proposals, which are summarized below.

2. Advertisements by Investment Advisers

Rule 206(4)-1 was adopted by the Commission to govern advertising by investment advisers. This rule prohibits advertisements containing a (1) testimonial, (2) partial lists of past recommendations that were or would have been profitable, (3) statements that graphs, charts, or other devices can be used to determine which securities to purchase and sell, and (4) offers of free services that are not free.

The Institute's 1998 submission to the Division recommended that the Commission repeal the substantive provisions of the rule and, in their place, adopt a single interpretive rule similar to Rule 156 under the Securities Act. In particular, we recommended that the rule be revised to: (1) prohibit advisers from using advertising that is materially false or misleading; (2) define as materially false or misleading any advertisement that contains an untrue statement of material fact or a material omission; and (3) provide general guidance on the presentation of advertisements, including a list of some factors and kinds of information or statements that may make an advertisement false or misleading, depending on the context in which it is used and how it is presented, explained, and qualified. In addition, the Institute recommended that the definition of "advertisement" in the rule be narrowed to encompass only public communications or, alternatively, communications directed to 10 or more persons, which an adviser is required to keep under Rule 204-2, the recordkeeping rule under the Advisers Act.

As discussed in detail in the Institute's 1998 submission, developments since the Rule 206(4)-1 was adopted in 1962 have rendered the specific prohibitions in the rule antiquated and unworkable, to the detriment of advisers and their clients. Consequently, today the rule unnecessarily restricts the communication of information by advisers to clients and prospective clients.[133] Moreover, the rule's "one-size-fits-all" approach does not allow advisers any flexibility to tailor communications to sophisticated clients, resulting in the rule prohibiting advisers from providing information that clients have specifically requested.[134] The rule also places investment advisers at a competitive disadvantage to other financial service providers who are permitted to advertise what advisers cannot.

3. Custody or Possession of Customer Funds or Securities

Rule 206(4)-2, which governs the custody or possession of customer funds or securities by an investment adviser, provides that it shall constitute a fraudulent, deceptive, or manipulative act for any registered investment adviser who has custody or possession of any customer funds or securities to do any act, directly or indirectly, with respect to such funds or securities unless the adviser has complied with specified conditions. These conditions require that: (1) the securities of each client be segregated; (2) the adviser deposit client funds in one or more bank accounts that contain only clients' funds, be named as the agent or trustee for the clients, and maintain records concerning deposits and withdrawals from the account; (3) the adviser provide notice to clients of the place and manner in which the funds and securities are held and send an itemized statement to clients regarding such funds or securities at least every three months; and (4) an independent public accountant annually verify by actual examination all such funds and securities, without prior notice to the adviser.

The Institute's 1998 submission recommended that Rule 206(4)-2 be revised to permit an adviser to keep custody of client funds or securities directly, through an affiliate of the adviser that meets certain specified conditions provided that: (1) notice of the arrangement is provided to clients; (2) the arrangement is governed by a written contract containing specified provisions; and (3) clients are provided a quarterly itemized account statement showing all activity in the client account. As an alternative to meeting the above conditions, the Institute's letter recommended that the rule allow an adviser to maintain custody if the client is provided specified disclosure and has given his or her informed written consent to the alternative arrangement. Finally, we recommended that the rule be amended to clarify that an adviser would not be subject to the rule solely because it or an affiliate may withdraw client assets from the client's account to pay advisory, custodial or administrative fees provided: the arrangement is authorized in advance by the client in writing; the client may terminate authorization at any time without penalty; and the client receives periodic statements from the adviser detailing the amount of and basis for all fees deducted from the account. In addition, the Institute recommended that the release adopting the rule amendments provide that certain specified arrangements would not be deemed to be custody for purposes of the rule; that all existing custody arrangements be grandfathered under the revised rule; and, that client securities may be maintained in book-entry form.

In support of these recommendations, the Institute's letter noted that the application of the current rule to specific arrangements has proved to be complex, confusing, and sometimes incomprehensible. These concerns are exacerbated by a variety of SEC staff interpretations expanding what the staff considers to be "custody." Compliance with conditions in the rule also has become unworkable as securities have become uncertificated. For example, while the rule requires all securities to be segregated and marked as to their ownership, physical segregation is impossible in the case of securities maintained in book-entry form. Book-entry also precludes the ability of an independent public accountant to make a physical examination of the clients' securities during a surprise audit. In addition, compliance with the requirement that clients' funds be placed in a "bank" is impossible for advisers who maintain custody of customer funds abroad because foreign banks do not qualify as "banks" under the Advisers Act. Also, compliance with the "bank" condition is impossible where customer funds are held with a registered clearing agency, transfer agent, or other non-bank financial institution that is typically involved in the security clearance and settlement or transfer process. Finally, the Institute's letter noted that the costs of complying with the annual surprise audit are significant and the audit may not provide meaningful protections to advisory clients given that it only occurs once a year and would not necessarily address all issues relevant to the safekeeping of client funds or securities.

The Institute's proposed revisions to Rule 206(4)-2 would address the problems identified with the current rule and permit advisers to maintain custody under clear, workable standards that provide meaningful protection for advisory clients. Consistent with the intent and purpose of Section 206 of the Advisers Act, our proposed revisions would also permit alternative custody arrangements so long as the client has given his or her informed consent to such arrangements and the adviser complies with other conditions designed to protect clients' funds and securities.

ENDNOTES

[1] 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 (enclosing Recommendations for New and Amended Rules Concerning Affiliated Transactions). The 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. A copy of the submission is attached as Appendix A.

[2] Specifically, the staff of the Division of Investment Management issued no-action relief under Section 17(a) of the Investment Company Act concerning in-kind redemptions by affiliated persons. Signature Financial Group, Inc. (pub. avail. December 28, 1999). In addition, the Commission has proposed amendments to Rule 17a-8 to expand the circumstances under which a merger involving affiliated investment companies can be effected without the need to obtain exemptive relief from Section 17(a) of the Investment Company Act. Investment Company Act Release No. 25259 (November 8, 2001).

[3] In light of recent Commission guidance concerning the application of the safe harbor in Section 28(e) of the Securities Exchange Act of 1934 to riskless principal transactions, the Institute reiterated its recommendation concerning the treatment of these transactions under Section 17 of the Investment Company Act. Letter from Craig S. Tyle, General Counsel, Investment Company Institute, to Harvey L. Pitt, Chairman, Securities and Exchange Commission, dated January 4, 2002.

[4] Protecting Investors: A Half Century of Investment Company Regulation, Division of Investment Management, U.S. Securities and Exchange Commission (May 1992) (1992 Study) at 493-95.

[5] The staff has granted no-action relief under Section 17(d) with respect to the aggregation of orders of advisory clients that include one or more investment companies. See, e.g., SMC Capital, Inc. (pub. avail. September 5, 1995) (orders involving publicly traded securities in the secondary markets), Massachusetts Mutual Life Insurance Company (pub. avail. June 7, 2000) (orders involving certain private placement securities).

[6] 1992 Study at 494-95.

[7] The Institute included this recommendation in a submission to the Division of Investment Management in 1995. Letter from Paul Schott Stevens, General Counsel, Investment Company Institute, to Barry P. Barbash, Director, Division of Investment Management, Securities and Exchange Commission, dated July 19, 1995 (enclosing Proposals to Improve Investment Company Regulation) (1995 Submission). We have revised our proposed rule language to incorporate new conditions concerning independent directors that were added to Rule 17d-1(d)(7) and other exemptive rules under the Investment Company Act as part of the Commission's fund governance rule amendments adopted early last year.

[8] See infra Section III.A.

[9] Rule 10f-3(b)(4).

[10] See 1992 Studyat 20.

[11] See, e.g., Rule 10f-3(b)(2)(i), which generally requires that purchases under the rule take place prior to the end of the first day on which any sales are made, at a price that is not more than the price paid by each other purchaser of securities in that offering or any concurrent offering of the securities. In addition, the rule generally prohibits funds from purchasing securities directly or indirectly from an affiliated underwriter. We also note that the Commission recently amended Rule 10f-3 and various other rules under the Investment Company Act involving potential conflicts of interest by adding conditions designed to enhance the independence and effectiveness of independent directors of funds relying on those rules. Investment Company Act Release No. 24816 (January 2, 2001).

[12] The Commission has changed the rule substantially since its adoption to expand the rule's exemptive scope and to make the rule less restrictive. In 1979, the Commission amended the rule to allow for the purchase of underwritten municipal securities; in 1985 to reflect changes in periodic reporting requirements for all funds; in 1993 to remove a requirement that fund boards annually review procedures adopted pursuant to the rule; and in 1997 to increase the amount of an offering that a fund may purchase and to include purchases of securities of foreign issuers or domestic reporting issuers in an eligible foreign offering. See Investment Company Act Release No. 10736 (June 14, 1979); Securities Act Release No. 6591 (July 1, 1985); Securities Act Release No. 7013 (September 17, 1993); Investment Company Act Release No. 22775 (July 31, 1997). Most recently, the Commission has proposed amendments that would expand Rule 10f-3 to permit a fund to purchase government securities in a syndicated offering. The proposed amendments also would modify the rule's quantitative limit on purchases. See Investment Company Act Release No. 24775 (November 29, 2000).

[13] The Institute also recommends that the Commission eliminate the requirement in Rule 10f-3(a)(3) that municipal bonds must be investment grade. Municipal bonds are the only asset class covered by the rule that is subject to such a rating requirement and there is no apparent justification for singling them out. Moreover, the requirement could produce an anomalous result when, for example, an issuer (such as an airline) offers both taxable and tax-exempt bonds as part of the same deal. A fund with an affiliated underwriter that is in the syndicate would only be permitted to purchase the taxable bonds if the tax-exempt bonds were not investment grade.

[14] Letter from Craig S. Tyle, General Counsel, Investment Company Institute, to Barry P. Barbash, Director, Division of Investment Management, Securities and Exchange Commission, dated August 11, 1998. We continue to strongly urge the Commission to reject suggestions to increase the frequency of mutual fund portfolio holdings disclosure. 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 July 17, 2001.

[15] We note that our recommendation is consistent with recent changes to generally accepted accounting principles (GAAP) for investment companies. See AICPA Audit and Accounting Guide–Audits of Investment Companies, December 1, 2000 (Investment Company Audit Guide). When approving the streamlining of the schedule of investments, the AICPA stated: "Meaningful information is not measured solely by volume; content and materiality also affect the qualify of the information presented. Focusing investors on material items within the financial statements provides more understandable and useful information without burdening investors with unnecessary details."

[16] The Investment Company Audit Guide currently makes no special provision for money market funds and, accordingly, they are required to disclose, at a minimum, their top 50 holdings. The Audit Guide thus will need to be modified in order for the Institute's recommendation to be realized.

[17] Investment Company Act Release No. 24816 (January 2, 2001).

[18] Item 13(b)(3) of Form N-1A.

[19] There is one exception. The requirements to disclose interests in transactions and to disclose relationships do not apply to transactions or relationships with affiliated persons of the fund (other than those specifically indicated). See Items 13(b)(7) and 13(b)(8) of Form N-1A.

[20] Item 13(b)(6) of Form N-1A.

[21] We note that there may be other instances besides those specifically identified below where the new requirements result in disclosure of information that is burdensome to obtain and not useful to investors.

[22] See Letter from Craig S. Tyle, General Counsel, Investment Company Institute, to Mr. Jonathan G. Katz, Secretary, Securities and Exchange Commission, dated January 28, 2000, at 24.

[23] See Investment Company Act Release No. 24832 (January 18, 2001).

[24] We note that these are the same recommendations that we made in our comment letter on the Commission's proposal to require this disclosure. See Letter from Craig S. Tyle, General Counsel, Investment Company Institute, to Jonathan G. Katz, Secretary, Securities and Exchange Commission, dated June 30, 2000.

[25] Specifically, we recommend that the federal tax rates be the historic tax rates for ordinary income and long-term capital gains applicable to investors (married filing jointly) with taxableincome of $55,000.

[26] See Remarks by Paul F. Roye, Director of Investment Management, U.S. Securities and Exchange Commission, "Challenges for the Mutual Fund Industry in the Competitive Frontier," 2000 Mutual Funds and Investment Management Conference, Palm Desert, CA, March 27, 2000.

[27] Letter from Craig S. Tyle, General Counsel, Investment Company Institute, to Paul F. Roye, Director, Division of Investment Management, Securities and Exchange Commission, dated April 11, 2000.

[28] Rule 145 provides that an "offer" or "sale" within the meaning of the Securities Act occurs when the security holders of a corporation are asked to vote or consent to a plan or agreement for: (i) reclassifications other than stock splits and changes in par value; (ii) mergers, consolidations and similar plans of acquisition except where the sole purpose of the transaction is to change an issuer's domicile; and (iii) certain transfers of assets for securities where there is a subsequent distribution of the securities to those voting on the transfer of assets.

[29] Securities Act Release No. 6611 (November 22, 1985).

[30] The Form N-14 disclosure concerning the proposed reorganization (Item 4) and the entities involved (Items 5 and 6) is similar to that required by Item 14 of Schedule 14A; disclosure concerning voting information (Item 7) is derived directly from Schedule 14A.

[31] Disclosure concerning fees, risk factors and the entities involved in the reorganization for open-end investment companies is derived from Form N-1A.

[32] The Commission's position with respect to reorganizations, except shell reorganizations, is that the vote of each target company shareholder constitutes a new investment decision, and thus an "offer" or "sale" under the Securities Act, entitling the shareholder to the disclosure and protections of the registration process. See Securities Act Release No. 5316 (October 6, 1972); see also Securities Act Release No. 5510 (July 3, 1974).

[33] Section 19(a) requires that such dividend payments be "accompanied" by the notification. Nevertheless, the Institute believes that the Commission may exercise its exemptive authority to clarify that notification in annual reports to shareholders is deemed to satisfy the requirements of Section 19(a).

[34] AICPA Audit and Accounting Guide – Audits of Investment Companies, December 1, 2000.

[35] Investment Company Act Release No. 24816 (January 2, 2001).

[36] Compliance with the new conditions of the exemptive rules is required after July 1, 2002.

[37] Under Rule 0-1(a)(6)(i), a person is an independent legal counsel with respect to the "disinterested directors" if:

(A) A majority of the disinterested directors reasonably determine in the exercise of their judgment (and record the basis for that determination in the minutes of their meeting) that any representation by the person of the company's investment adviser, principal underwriter, administrator (management organizations), or any of their control persons, since the beginning of the fund's last two completed fiscal years, is or was sufficiently limited that it is unlikely to adversely affect the professional judgment of the person in providing legal representation to the disinterested directors; and

(B) The disinterested directors have obtained an undertaking from such person to provide them with information necessary to make their determination and to update promptly that information when the person begins to represent, or materially increases his representation of, a management organization or control person.

[38] Letter from Paul F. Roye, Director, Division of Investment Management, Securities and Exchange Commission, to Craig S. Tyle, Esq., General Counsel, Investment Company Institute, dated February 12, 2002.

[39] See Letter from Craig S. Tyle, General Counsel, Investment Company Institute, to Mr. Jonathan G. Katz, Secretary, Securities and Exchange Commission, dated January 28, 2000.

[40] The relevant exemptive rules are: Rule 10f-3, Rule 12b-1, Rule 15a-4, Rule 17a-7, Rule 17a-8, Rule 17d-1(d)(7), Rule 17e-1, Rule 17g-1(j), Rule 18f-3, and Rule 23c-3.

[41] Investment Company Act Release No. 16504, at 34 (July 29, 1988).

[42] This change will also require the addition of a definition of "contingent deferred sales load" to the rule. We note that in its release adopting Rule 6c-10, the Commission stated that a contingent deferred sales load is "a sales charge that is paid at redemption; its amount declines over several years until it reaches zero." Investment Company Act Release No. 20916, at 1 (February 23, 1995).

[43] Rule 12d3-1 defines "securities related activities" to mean a person's activities as a broker, a dealer, an underwriter, an investment adviser registered under the Investment Advisers Act, or an investment adviser to a registered investment company.

[44] The rule also imposes significant compliance burdens. In particular, determining what percentage of an issuer's gross revenues, in its most recent fiscal year, was derived from securities related activities often is difficult because financial statements and other publicly available documents are not required to provide this information and it may not be feasible to obtain it from the issuer's chief financial officer (as provided in Rule 12d3-1(d)(2)). In connection with proposing any amendments to Rule 12d3-1, the Commission should consider ways to ease this burden.

[45] In addition to our specific recommendations, we encourage the Commission to explore other potential ways to increase fund investment flexibility under Rule 12d3-1, such as excluding from the rule's restrictions investments in issuers that have no, or only a de minimis, other relationship with the fund.

[46] See Investment Company Act Release No. 13724, at n.9 and accompanying text (January 17, 1984) (Release 13724).

[47] Investment Company Act Release No. 19204, at 9-10 (January 4, 1993) (Release 19204).

[48] Indeed, the proviso in a predecessor rule (Rule 12d-1) intended to address the same potential abuses contained no asset limit but rather only investment limits, although the predecessor rule did have other restrictions not found in the current rule. Release 19204, at n.8. See also Investment Company Act Release No. 4044 (September 4, 1964) (adopting Rule 12d-1).

[49] Investment Company Act Release No. 14036, at 10-11 (July 13, 1984). The release proposing Rule 12d3-1 indicated that the five percent asset limit was "modeled after a condition contained in recent exemptive orders" under Section 12(d)(3) and Rule 12d3-1. Release 13724, at 18. Among other conditions, those exemptive orders limited fund investments in any class of securities issued by certain securities related issuers to ten percent of the fund's total assets or, if lower, the maximum amount permitted by the fund's investment policies and restrictions. See American Express Company, Investment Company Act Release Nos. 12987 (January 21, 1983) (notice) and 13061 (March 2, 1983) (order); Kemper Corp., Investment Company Act Release Nos. 13249 (May 17, 1983) (notice) and 13319 (June 14, 1983) (order).

[50] To illustrate, certain securities related issuers comprise more than five percent of the Standard & Poor's financial sector index. See Financial Select Sector SPDR Fund, Diamonds Trust (pub. avail. July 6, 2000).

[51] The Commission has, through a no-action letter and a number of exemptive orders, permitted increases in the five percent asset limit for certain investment companies, the portfolios of which represent a stock index or a mechanically selected subset of the stocks in an index. See, e.g., Financial Select Sector SPDR Fund, Diamonds Trust, (pub. avail. July 6, 2000); Investec Ernst & Company, et al., Investment Company Act Release Nos. 25115 (August 17, 2001) (notice) and 25155 (September 12, 2001) (order); Legg Mason

Wood Walker, Inc., et al., Investment Company Act Release Nos. 25101 (August 3, 2001) (notice) and 25148 (September 4, 2001) (order).

[52] Again, to illustrate, certain securities-related issuers comprise more than five percent of the Dow Jones Industrial Average. See Financial Select Sector SPDR Fund, supra note 50.

[53] See Investment Company Act Release No. 24816 (January 2, 2001).

[54] See, e.g., The Vantagepoint Funds and Vantagepoint Investment Advisers, LLC, Investment Company Act Release Nos. 25446 (February 26, 2002) (notice) and 25496 (March 22, 2002) (order); AXA Premier Funds Trust, et al., Investment Company Act Release Nos. 25323 (December 20, 2001) (notice) and 25369 (January 16, 2002) (order); CDC IXIS Asset Management Advisers, L.P., et al., Investment Company Act Release Nos. 25061 (July 12, 2001) (notice) and 25103 (August 8, 2001) (order); AB Funds Trust, et al., Investment Company Act Release Nos. 24999 (June 7, 2001) (notice) and 25054 (June 29, 2001) (order); SEI Investments Management Corporation, et al., Investment Company Act Release Nos. 24430 (April 28, 2000) (notice) and 24463 (May 23, 2000) (order); PaineWebber Group, Inc., et al., Investment Company Act Release Nos. 23871 (June 15, 1999) (notice) and 23893 (July 7, 1999) (order); The Goldman Sachs Group, Inc., et al., Investment Company Act Release Nos. 23772 (April 7, 1999) (notice) and 23816 (June 4, 1999) (order).

[55] Accounting Release No. 27, Investment Company Act Release No. 279 (December 11, 1941).

[56] See Investment Company Act Release No. 172 (July 31, 1941) (Rule N-17F-2 . . . in substance codifies certain accepted practices more or less generally followed at present in the management of securities.). Although Rule 17f-2 has been amended twice since its adoption in 1941, the original conditions in the rule remain unchanged.

[57] It is worth noting the distinction between uncertificated securities and securities that, whether certificated or uncertificated, are held by investors through what Article 8 of the Uniform Commercial Code characterizes as the “indirect holding system.” The indirect holding system is a means of holding securities through book-entries, but it should not be confused with self-custody. Funds that hold certificated or uncertificated securities “indirectly” hold them through custodians in accordance with Section 17(f) and, since those custodians usually utilize securities depositories, generally pursuant to Rule 17f-4. It should be literally impossible for a fund to “self-custody” a security for purposes of Rule 17f-2 while using the indirect holding system. As discussed in the text below, however, this important, conceptual distinction is blurred by the staff’s view that funds “self-custody” securities whenever they use affiliated custodians.

[58] Gardner Fund (pub. avail. March 7, 1988). See also Ameritrust Collective Investment Retirement Fund (pub. avail. November 23, 1987), and American Pension Investors Trust (pub. avail. February 1, 1991) (allowing a fund’s custodian to hold securities with an issuing fund’s transfer agent).

[59] Investment Company Act Release No. 25266 (November 15, 2001) (Rule 17f-4 Proposal), subparagraph (a)(4)(iii) of Proposed Rule 17f-4.

[60] Letter from Amy B.R. Lancellotta, Senior Counsel, Investment Company Institute, to Jonathan G. Katz, Secretary, Securities and Exchange Commission, dated January 31, 2002, at 10. In that letter, the Institute recommended that the Commission not define transfer agents as securities depositories in part because transfer agents function as a part of the direct holding system, whereas securities depositories act as part of the indirect holding system.

[61] Pegasus Income & Capital Fund, Inc. (pub. avail. December 31, 1977).

[62] Mutual Fund Group (pub. avail. December 12, 1989).

[63] IPI-Income & Price Index Fund (pub. avail. December 12, 1980); Composite Group of Funds (pub. avail. March 2, 1987).

[64] The Rodney Square Fund (pub. avail. June 15, 1987) (independent sub-custodians; fund auditors would reconcile records maintained by the fund, its custodian and various securities depositories); Mutual Fund Group, supra note 62. (none of the officers, directors or employees of the custodian would be an officer, director or employee of the fund); IPI-Income & Price Index Fund, supra note 63. (none of the officers, directors or employees of the fund would be permitted to withdraw fund assets or would have access to fund assets).

[65] Pub. L. No. 106-102, 113 Stat. 1338 (1999), §211.

[66] To the extent necessary, the Commission should be able to apply to non-bank affiliated custodians the same substantive requirements that it imposes on affiliated bank custodians. For example, Rule 17f-5 could be modified to apply these requirements

with respect to affiliated foreign custodians.

[67] See, e.g., Washington Square Cash Fund (pub. avail. July 9, 1990); Carnegie-Cappiello Growth Trust (pub. avail. August 8, 1985); IPI-Income and Price Index, supra note 63.

[68] See Mutual Fund Group, supra note 62.

[69] Letter from Paul Schott Stevens, Senior Vice President and General Counsel, Investment Company Institute, to Barry P. Barbash, Director, Division of Investment Management, Securities and Exchange Commission, dated March 13, 1996 (1996 Letter). A copy of the letter is attached as Appendix B.

[70] As additional support for such a cap, the 1996 Letter cited the finite availability of joint fidelity bond coverage at that time. We understand that, due to increased capacity in the insurance industry, this is no longer an issue.

[71] Investment Company Act Release No. 9399, at 31 (April 7, 1993). The Commission adopted Rule 6c-10 in 1995.

[72] The Institute made the same recommendation in our 1995 Submission. In addition to interval funds, other types of closed-end funds could benefit from being able to use such distribution financing arrangements. A commenter on proposed Rule 23c-3 expressed the view that "there is nothing in the 1940 Act that prohibits payment of distribution expenses by a closed-end fund and … it would be appropriate for the Commission to clarify this point in the adopting release." See Letter from the Subcommittee on Investment Companies and Investment Advisers of the American Bar Association's Section of Business Law to Jonathan G. Katz, Secretary, Securities and Exchange Commission, dated November 2, 1992. This view was subsequently expressed by commenters on proposed amendments to Rule 6c-10. See Letter from Davis Polk & Wardwell to Jonathan G. Katz, Secretary, Securities and Exchange Commission, dated April 14, 1995; Letter from the Subcommittee on Investment Companies and Investment Advisers of the American Bar Association's Section of Business Law to Jonathan G. Katz, Secretary, Securities and Exchange Commission, dated April 12, 1995. The Institute recommends that further consideration be given to clarifying the ability of all closed-end funds to impose CDSLs and ABSCs.

[73] See, e.g., ING Pilgrim Investments, LLC, et al., Investment Company Act Release Nos. 25167 (September 21, 2001) (notice) and 25212 (October 17, 2001) (order); ING Pilgrim Investments, LLC, et al., Investment Company Act Release Nos. 24881 (February 28, 2001) (notice) and 24916 (March 27, 2001) (order); Scudder Weisel Capital Entrepreneurs Fund and Scudder Weisel Capital LLC, Investment Company Act Release Nos. 24805 (December 27, 2000) (notice) and 24833 (January 19, 2001) (order); ING Pilgrim Investments, LLC, et al., Investment Company Act Release Nos. 24881 (February 28, 2000) (notice) and 24916 (March 27, 2001) (order); AIM Advisors, Inc., Investment Company Act Release Nos. 24110 (October 25, 1999) (notice) and 24149 (November 22, 1999) (order); Nuveen Floating Rate Fund, Investment Company Act Release Nos. 24066 (October 1, 1999) (notice) and 24114 (October 27, 1999) (order); Stein Roe Floating Rate Income Fund, Investment Company Act Release Nos. 24014 (September 15, 1999) (notice) and 24078 (October 13, 1999) (order); Oppenheimer Senior Floating Rate Fund, Investment Company Act Release Nos. 23945 (August 12, 1999) (notice) and 23992 (September 2, 1999) (order); Kemper Floating Rate Fund, Investment Company Act Release Nos. 23811 (April 27, 1999) (notice) and 23846 (May 24, 1999) (order); CypressTree Asset Management Corporation, et al., Investment Company Act Release Nos. 23312 (July 10, 1998) (notice) and 23378 (August 15, 1998) (order); Franklin Floating Rate Trust, Investment Company Act Release Nos. 23033 (February 20, 1998) (notice) and 23068 (March 17, 1998) (order); and Eaton Vance Management, et al., Investment Company Act Release Nos. 22670 (May 19, 1997) (notice) and 22709 (June 16, 1997) (order).

[74] For example, one of the requirements of Rule 6c-10 is that the terms of the deferred sales load must be covered by the provisions of NASD Conduct Rule 2830 (Sales Charge Rule). In approving a proposed rule change exempting interval funds from the NASD Corporate Financing Rule and applying the Sales Charge Rule to these funds, the Commission stated that it "agrees that interval funds, because their manner of financing the distribution of shares are more similar to that of open-end funds, are more properly regulated by NASD Conduct Rule 2830, which regulates the distribution and sales charges of open-end funds." Securities Exchange Act Release No. 42965 (June 20, 2000).

[75] Rule 17d-3 under the Act provides an exemption from Section 17(d) and Rule 17d-1 to permit fund affiliates and principal underwriters to receive distribution payments.

[76] This recommendation is consistent with the Division of Investment Management's recommendation in the 1992 Study that Section 8(b) and Section 13(a)(2) of the Investment Company Act be amended to exclude "security-based loans" and to eliminate the requirement of a shareholder vote to approve a change in either direction in an investment company's concentration policy, to require that investment companies label themselves as "industry diversified" or "industry non-diversified," and to require a shareholder vote to change a classification from "industry diversified" to "industry non-diversified." As noted in the Institute's 1995 Submission, the Division apparently determined subsequently that these concerns could be addressed administratively, instead of through legislative

changes.

[77] 1992 Study at 279.

[78] Id. at 280.

[79] Id.

[80] 1992 Study at 280.

[81] Practically all variable life insurance contracts are funded by separate accounts organized as unit investment trusts.

[82] The exemptive relief provided by paragraph (b)(15) of Rule 6e-2, which is dependent upon satisfaction of the "exclusivity requirement," includes: (1) a limitation on the application of eligibility restrictions of Section 9(a) of the Act; (2) extending the ability to "veto" voting rights under certain limited circumstances as provided to separate accounts organized as management investment companies under other provisions of Rule 6e-2; (3) relief from the seed capital requirements of Section 14(a) of the Act; and (4) relief from requirements that an underlying fund hold an initial meeting of its shareholders to satisfy voting requirements under Sections 15(a), 16(a), and 32(a)(2) of the Act.

[83] The exemptive relief provided by paragraph (b)(15) of Rule 6e-3(T) is substantially similar to that provided by paragraph (b)(15) of Rule 6e-2.

[84] Investment Company Act Release No. 9483 (October 18, 1976).

[85] Investment Company Act Release No. 14234, 1984 SEC LEXIS 2512, at *46 (November 14, 1984).

[86] Investment Company Act Release No. 15651, 1987 SEC LEXIS 2217, at *74 (footnotes omitted) (March 30, 1987).

[87] See, e.g., DFA Investment Dimensions Group Inc., Investment Company Act Release Nos. 25421 (February 13, 2002) (notice) and 25459 (March 12, 2002) (order); Touchstone Variable Series Trust, Investment Company Act Release Nos. 25305 (December 3, 2001) (notice) and 25352 (December 31, 2001) (order); Nations Separate Account Trust, Investment Company Act Release Nos. 25096 (July 31, 2001) (notice) and 25139 (August 24, 2001) (order); Met Investors Series Trust, Investment Company Act Release Nos. 24997 (June 5, 2001) (notice) and 25057 (July 3, 2001) (order); Advantus Series Fund, Investment Company Act Release Nos. 24778 (November 30, 2000) (notice) and 24800 (December 27, 2000) (order); The Ayco Company, Investment Company Act Release Nos. 24747 (November 22, 2000) (notice) and 24792 (December 18, 2000) (order); Summit Mutual Funds, Inc., Investment Company Act Release Nos. 24734 (November 9, 2000) (notice) and 24783 (December 4, 2000) (order); The Wachovia Variable Insurance Funds, Investment Company Act Release Nos. 24696 (October 25, 2000) (notice) and 24740 (November 15, 2000) (order); Mutual of America Investment Corporation, Investment Company Act Release Nos. 24691 (October 17, 2000) (notice) and 24732 (November 8, 2000) (order); WM Variable Trust, Investment Company Act Release Nos. 24679 (October 5, 2000) (notice) and 24723 (October 31, 2000) (order); Hartford Capital Appreciation HLS Fund Inc., Investment Company Act Release Nos. 24676 (October 3, 2000) (notice) and 24724 (November 1, 2000) (order); Brazos Insurance Funds, Investment Company Act Release Nos. 24632 (September 1, 2000) (notice) and 24667 (September 27, 2000) (order); Nationwide Separate Account Trust, Investment Company Act Release Nos. 24619 (August 23, 2000) (notice) and 24647 (September 19, 2000) (order); First American Insurance Portfolios, Inc., Investment Company Act Release Nos. 24601 (August 18, 2000) (notice) and 24640 (September 13, 2000) (order); Potomac Insurance Trust, Investment Company Act Release Nos. 24544 (June 22, 2000) (notice) and 24560 (July 18, 2000) (order); Warburg, Pincus Trust, Investment Company Act Release Nos. 24442 (May 5, 2000) (notice) and 24482 (May 30, 2000) (order); The Kelmoore Strategy TM Variable Trust, Investment Company Act Release Nos. 24399 (April 19, 2000) (notice) and 24454 (May 16, 2000) (order); ING Variable Insurance Trust, Investment Company Act Release Nos. 24380 (April 6, 2000) (notice) and 24439 (May 3, 2000) (order); Calamos Advisors Trust, Investment Company Act Release Nos. 24332 (March 7, 2000) (notice) and 24375 (April 3, 2000) (order); Seligman Portfolios, Inc., Investment Company Act Release Nos. 24323 (February 29, 2000) (notice) and 24366 (March 24, 2000) (order); Third Avenue Variable Series Trust and ESQF Advisers, Inc., Investment Company Act Release Nos. 24251 (January 12, 2000) (notice) and 24281 (February 8, 2000) (order).

[88] Recent exemptive orders have permitted underlying fund shares to be offered to and held by the same categories of purchasers as permitted by Treasury Regulations implementing the diversification requirements imposed on Variable Contracts by Section 817(h) of the Internal Revenue Code of 1986. The Treasury Regulations generally permit shares of an underlying fund to be held by the trustee of a qualified plan, by the fund's investment adviser or certain affiliates of the adviser, and by the insurer and certain affiliates without adversely affecting the tax treatment of the Variable Contracts. Treas. Reg. 1.817-5(f)(3).

[89] Generally, mixed and shared funding orders provide that these steps could include: (1) withdrawing the assets from the underlying fund and reinvesting such assets in a different investment medium, including another underlying fund; (2) submitting the question as

to whether such segregation should be implemented to a vote of all affected Variable Contract owners and, as appropriate, segregating the assets of a class of shareholders that votes in favor of such segregation; (3) offering to the affected shareholders the option of making such a change; or (4) establishing a new underlying fund or a managed separate account.

[90] Applications for mixed and shared funding typically state that a material irreconcilable conflict may arise for a variety of reasons, including: (1) an action by any state insurance regulatory authority; (2) a change in applicable federal or state insurance, tax, or securities laws or regulations, or a public ruling, private letter ruling, no-action or interpretative letter, or any similar action by insurance, tax, or securities regulatory authorities; (3) an administrative or judicial decision in any relevant proceeding; (4) the manner in which the investments of an underlying fund are being managed; (5) a difference in voting instructions given by any class of shareholders; (6) a decision by an insurer to disregard the voting instructions of variable contract owners; or (7) if applicable, a decision by the fiduciary of a qualified plan to disregard voting instructions of its participants.

[91] See Diane Ambler, Transcript of the Conference on the Role of Independent Investment Company Directors, U.S. Securities and Exchange Commission, Washington, D.C., February 24, 1999 (The Commission has imposed on fund boards the obligation to monitor for any potential material irreconcilable conflicts in relation to having unaffiliated companies and different types of products. . . . In my experience, there has been very little that has ever been presented to the board that would raise to the level of a material irreconcilable conflict.) (emphasis added).

[92] Formerly Section 26(b) of the Investment Company Act, this provision was re-designated Section 26(c) effective May 12, 2001 in the Gramm-Leach-Bliley Act of 1999, Pub. L. No. 106-102, 113, § 201, Stat. 1338 (November 12, 1999).

[93] Pub. L. No. 91-547, 84 Stat. 1413 (December 14, 1970).

[94] See, e.g., Integrity Life Insurance Company, Investment Company Act Release Nos. 25490 (March 20, 2002) (notice) and 25530 (April 16, 2002) (order); Jefferson Pilot Financial Insurance Company, Investment Company Act Release Nos. 25453 (March 6, 2002) (notice) and 25506 (April 2, 2002) (order); Massachusetts Mutual Life Insurance Company, Investment Company Act Release Nos. 25365 (January 15, 2002) (notice) and 25412 (February 8, 2002) (order); First Allmerica Financial Life Insurance Company, Investment Company Act Release Nos. 25311 (December 5, 2001) (notice) and 25349 (December 28, 2001) (order); First Variable Life Insurance Company, Investment Company Act Release Nos. 25308 (December 4, 2001) (notice) and 25347 (December 28, 2001) (order); Golden American Life Insurance Company, Investment Company Act Release Nos. 25221 (October 23, 2001) (notice) and 25302 (November 29, 2001) (order); Equitable Life Assurance Society of the United States, Investment Company Act Release Nos. 24936 (April 10, 2001) (notice) and 24975 (May 8, 2001) (order); New England Life Insurance Company, Investment Company Act Release Nos. 24925 (April 5, 2001) (notice) and 24965 (April 27, 2001) (order); Allianz Life Insurance Company of North America, Investment Company Act Release Nos. 24889 (March 9, 2001) (notice) and 24920 (March 29, 2001) (order); New England Life Insurance Company, Investment Company Act Release Nos. 24733 (November 8, 2000) (notice) and 24779 (December 1, 2000) (order); National Life Insurance Company, Investment Company Act Release Nos. 24728 (November 3, 2000) (notice) and 24750 (November 27, 2000) (order); The Variable Annuity Life Insurance Company, Investment Company Act Release Nos. 24714 (October 26, 2000) (notice) and 24742 (November 17, 2000) (order); American Skandia Life Assurance Corporation, Investment Company Act Release Nos. 24688 (October 13, 2000) (notice) and 24729 (November 6, 2000) (order); Equitable Life Assurance Society of the United States, Investment Company Act Release Nos. 24603 (August 21, 2000) (notice) and 24643 (September 18, 2000) (order); First Allmerica Financial Life Insurance Company, Investment Company Act Release Nos. 24444 (May 5, 2000) (notice) and 24483 (May 31, 2000) (order); Penn Mutual Life Insurance Company, Investment Company Act Release Nos. 24387 (April 11, 2000) (notice) and 24436 (May 2, 2000) (order); Alexander Hamilton Life Insurance Company of America, Investment Company Act Release Nos. 24374 (April 3, 2000) (notice) and 24427 (April 28, 2000) (order); Pacific Life Insurance Company, Investment Company Act Release Nos. 24237 (January 11, 2000) (notice) and 24277 (February 3, 2000) (order); Golden American Life Insurance Company, Investment Company Act Release Nos. 24230 (December 30, 1999) (notice) and 24265 (January 27, 2000) (order); Provident Mutual Life Insurance Company, Investment Company Act Release Nos. 24229 (December 30, 1999) (notice) and 24266 (January 27, 2000) (order); Hartford Life and Annuity Insurance Company, Investment Company Act Release Nos. 24205 (December 17, 1999) (notice) and 24250 (January 12, 2000) (order).

[95] In some applications, applicants represented that funds proposed for substitution would have expense limitation arrangements, and the staff has sometimes requested such limits. See, e.g., SAFECO Life Insurance Company, Investment Company Act Release Nos. 24187 (December 7, 1999) (notice) and 24225 (December 29, 1999) (order) and Aetna Life Insurance and Annuity Company, Investment Company Act Release Nos. 22765 (July 25, 1997) (notice) and 22794 (August 21, 1997) (order).

[96] Paul F. Roye, Director, Division of Investment Management, U.S. Securities and Exchange Commission, Remarks before the American Law Institute -American Bar Association, Life Insurance Company Products Conference (October 25, 2001).

[97] See, e.g., Pacific Life Insurance Company, Investment Company Act Release Nos. 24237 (January 11, 2000) (notice) and 24277 (February 3, 2000) (order) (substitution by insurer to prevent a fund from decreasing in size after distributor stopped offering the

fund).

[98] AIG Life Insurance Company, 2001 Investment Company Act No-Act. LEXIS 783 (pub. avail. August 16, 2001).

[99] Id. at *14.

[100] Id.

[101] One of the conditions in the Institute's proposed rule would require that, at the time of substitution, the fees and expenses of the new portfolio company are equal to or less than the fees and expenses of the existing portfolio company. This condition reflects the Institute's view that the staff should not condition approval under Section 26(c) upon a vote of Variable Contract owners where a new fund has a distribution plan under Rule 12b-1, but its expenses are actually equal to or less than the expenses of the existing fund which does not have such a distribution plan. The staff has accepted this principle in at least one order approving a substitution. See American United Life Insurance Company, Investment Company Act Release Nos. 24784 (December 4, 2000) (notice) and 24801 (December 27, 2000) (order).

[102] See id.

[103] See supra note 94.

[104] The proposition that applicants may substantially comply with the conditions in Rule 17a-7 has been accepted by the staff in an order approving a substitution. See Equitable Life Assurance Society of the United States, Investment Company Act Release Nos. 24936 (April 10, 2001) (notice) and 24975 (May 8, 2001) (order); see also Equitable Life Assurance Society of the United States, Investment Company Act Release Nos. 24603 (August 21, 2000) (notice) and 24643 (September 18, 2000) (order).

[105] Insurers and underlying funds cannot rely on the exemption provided in Rule 17a-7 in connection with In-Kind Transactions in substitutions because the bases for the affiliations between the parties are likely to be other than solely by reason of having a common investment adviser, common directors, and/or common officers, as required by the rule. Moreover, one of the conditions enumerated in Rule 17a-7 requires that the transaction be a purchase or sale, for no consideration other than cash payment against prompt delivery of a security for which market quotations are readily available. This condition cannot be met in the In-Kind Transactions involved in a substitution because there is no cash payment in either the redemption-in-kind from the existing underlying fund or the purchase of shares with assets other than cash from the replacing underlying fund.

[106] See supra Section III.A.

[107] The reports are filed on the Commission's EDGAR system and can be accessed by the public over the Internet.

[108] This study was conducted pursuant to Section 19(a) of the Exchange Act (Pub. L. 90-438, amended by 91-410, September 25, 1970) [15 U.S.C. 78s(a)].

[109] H.R. Doc. No. 64, 92d Cong., 1st Sess. 1971.

[110] Report of the Senate Subcommittee on Securities, Committee on Banking, Housing, and Urban Affairs, 93rd Cong., 1st Sess. (Comm. Print 1973).

[111] See Securities Exchange Act Release No. 14852, at 5 (June 15, 1978) (Adopting Release).

[112] See Report of the Senate Committee on Banking, Housing, and Urban Affairs (Senate Report No. 75, 94th Cong., 1st Sess. 85 (1975)).

[113] 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 July 17, 2001 (July 2001 Letter).

[114] These practices also would be harmful to other clients of institutional investment managers filing 13F Reports.

[115] Section 13(f)(1) provides that "in no event shall [13F Reports] be filed for periods longer than one year or shorter than one quarter."

[116] See Securities Exchange Act Release No. 13396 (March 22, 1977).

[117] See Adopting Release at 30-31.

[118] Securities Exchange Act Release No. 15461, at 6 (January 5, 1979).

[119] Id.

[120] See Adopting Release at 17.

[121] Russ Wermers, "The Potential Effects of More Frequent Portfolio Disclosure on Mutual Fund Performance," Perspective, Vol. 7, No. 3, June 2001, Investment Company Institute, at 8. Although the study focused specifically on disclosure of mutual fund portfolio holdings, the same principles would apply in the context of 13F Reports.

[122] An "illiquid security" is "any security that cannot be disposed of within seven days in the ordinary course of business at approximately the amount at which the company has valued the instrument." See Investment Company Act Release No. 14983 (March 12, 1986).

[123] Most commercial paper is issued in reliance on Section 3(a)(3) of the Securities Act. Section 3(a)(3) exempts "any note . . . which arises out of a current transaction or the proceeds of which have been or are to be used for current transactions, and which has a maturity at the time of issuance not exceeding nine months." Commercial paper that does not meet the requirements of Section 3(a)(3) because the proceeds are not necessarily being used for "current transactions" must be issued in reliance on Section 4(2) of the Securities Act, which exempts "transactions by an issuer not involving a public offering." 4(2) Paper is considered a "restricted" security because it may be resold only if the offering is registered under the Securities Act or the sale is effected in a private transaction exempt from registration.

[124] Merrill Lynch Money Markets Inc. (pub. avail. January 14, 1994) (Merrill Lynch). In Merrill Lynch, the staff stated that a fund's board may determine that an issue of 4(2) Paper is liquid if three conditions are satisfied: (1) the 4(2) Paper must not be traded flat or in default as to principal or interest; (2) the 4(2) Paper must be rated in one of the two highest rating categories by at least two NRSROs, or if only one NRSRO rates the security, by that NRSRO; if the security is unrated, the board must determine that the security is of equivalent quality; and (3) the board must consider the trading market for the specific security, taking into account all relevant factors.

[125] Id. at 5.

[126] The commercial paper market is highly liquid and concentrated. As of January, 2002 commercial paper outstanding in the United States exceeded $993 billion with more than $25 billion transacted daily. See Daily Federal Reserve Commercial Paper Release, www.federalreserve.gov/releases.

[127] See Merrill Lynch, supra note 124.

[128] Where an issuer has a combination of 3(a)(3) Paper and 4(2) Paper, each type of paper receives the same rating by Standard & Poor's. Moody's rates issuers, not issues, and, as such, does not distinguish between a particular issuer's 3(a)(3) and 4(2) Paper. Id.

[129] Federal Reserve Banks allow broker-dealers to obtain 100 percent collateral value on both types of commercial paper. Id.

[130] There may be other securities that also should not be presumed to be illiquid. For example, it is our understanding that the market for Rule 144A securities, like the 4(2) Paper market, is broadly accessible and highly liquid.

[131] See 1992 Study at 266.

[132] Letter from Craig S. Tyle, General Counsel, Investment Company Institute, to Barry P. Barbash, Director, Division of Investment Management, Securities and Exchange Commission, dated July 7, 1998. A copy of the Institute's 1998 submission is attached as Appendix C. The 1998 submission also recommended revisions to Rule 206(4)-4, which requires investment advisers to disclose certain material financial and disciplinary information to customers. Our current submission does not include our previous recommendations relating to Rule 206(4)-4 because the SEC's proposed amendments to Form ADV are expected to address the concerns we raised in 1998 with the rule.

[133] For example, Rule 206(4)-1 prohibits an advertisement, which includes any letter addressed to more than one person, from referring, directly or indirectly, to past specific recommendations of the adviser that were or would have been profitable to any person, unless certain conditions are satisfied. It is not uncommon for an institutional client or prospect to request that an investment adviser provide real life illustrations demonstrating the methodology used in picking securities. Given that these illustrations may show whether the investment was profitable, they are prohibited under the rule as fraudulent or deceptive, even when they are specifically requested by a client. As such, the rule has a far reaching effect and reaches conduct that would be neither fraudulent nor deceptive.

[134] We note that the Commission recently published for comment a proposal by NASD Regulation, Inc. to amend its rules relating to

communications with the public to recognize a distinction in the regulatory treatment of communications depending upon whether the intended audience consists of retail or institutional investors. See Securities Exchange Act Release No. 45181 (December 31, 2001).