

## Comment Letter Regarding SEC Guidance on Riskless Principal Transactions, January 2002

January 4, 2002

Mr. Harvey L. Pitt  
Chairman  
Securities and Exchange Commission  
450 Fifth Street, N.W.  
Washington, D.C. 20549

### Re: Riskless Principal Transactions Under the Investment Company Act

Dear Chairman Pitt:

The Investment Company Institute<sup>1</sup> is writing to request that the Commission reexamine the treatment of riskless principal transactions under Section 17 of the Investment Company Act of 1940 in light of the recent guidance it issued regarding the application of the safe harbor in Section 28(e) of the Securities Exchange Act of 1934 to these transactions.<sup>2</sup>

Section 17(a) of the Investment Company Act prohibits a fund from engaging in principal transactions, including riskless principal transactions, with an affiliate. For all practical purposes, however, riskless principal transactions more closely resemble agency transactions than traditional principal transactions and, thus, do not present the possibilities for abuse that Section 17(a) was designed to address. For example, when a fund purchases a security from an affiliated broker-dealer in a riskless principal transaction, that broker-dealer is simultaneously acquiring that security from another party. It is not selling the security out of its inventory. Thus, the broker-dealer is acting like an agent for all intents and purposes, even though the transaction is structured so that title momentarily passes through the broker-dealer.

The Commission staff considered the regulation of these transactions under the Investment Company Act in 1992, at which time it decided against adopting a rule to exempt them from Section 17(a) "because of the substantive differences between agency and riskless principal transactions."<sup>3</sup> In particular, the staff expressed concern that (1) because the affiliated dealer would deal directly with both the purchaser and seller, "it is possible that a transaction might be initiated by an affiliate in order to dump overpriced securities as a favor to another customer," and (2) monitoring price and execution for many riskless principal transactions is much more difficult than for agency transactions, in large part because of the lack of information about the prices of fixed income securities.

Since 1992, the Institute has made two submissions to the Commission staff recommending that the Commission adopt an exemptive rule under Section 17(a) for riskless principal transactions.<sup>4</sup> Under our proposal, riskless principal transactions would be subject to standards similar to those applicable to agency trades involving affiliated brokers under Rule 17e-1.

The Institute continues to urge the Commission to adopt such an exemptive rule for riskless principal transactions generally. In the meantime, however, we recommend that the Commission issue interpretive guidance to clarify that those riskless principal transactions that fall within the scope of the Commission's recent Section 28(e) interpretive guidance will be treated like agency transactions and, thus, not subject to the prohibition of Section 17(a).

In its recent interpretive guidance, the Commission clarified that certain riskless principal transactions effected by members of the National Association of Securities Dealers, Inc. are within the scope of the Section 28(e) safe harbor. The Commission's position was based on the transparency achieved in the Nasdaq market for certain transactions. In particular, the Commission's position was conditioned on both legs of the transaction being executed at the same price and disclosure of this price on a confirmation that also fully discloses the remuneration paid to the NASD member for effecting the transaction.

The conditions in the Commission's interpretation address the concerns expressed by the Commission staff in 1992. First, the requirement that both legs be executed at the same price validates the price of the trade and, thus, alleviates any concerns about an

affiliate dumping overpriced securities to favor one client over another. Second, the requirement that the price at which the transaction is effected and the remuneration paid to the broker-dealer for effecting the transaction be fully disclosed addresses any concern about the ability to monitor the price and execution. This concern is also addressed by the fact that the interpretation applies only to those transactions with a certain level of transparency.<sup>5</sup>

Accordingly, we believe that the same policy considerations that underlie the Commission's Section 28(e) guidance support treating at least some riskless principal transactions in the same manner as agency transactions under Section 17 of the Investment Company Act. We therefore request that the Commission issue interpretive guidance to this effect.

If you have any questions or comments regarding our request, please contact the undersigned at 202/326-5815.

Sincerely,

Craig S. Tyle  
General Counsel

cc: Paul F. Roye, Director  
Division of Investment Management

#### **ENDNOTES**

<sup>1</sup> The Investment Company Institute is the national association of the American investment company industry. Its membership includes 9,063 open-end investment companies ("mutual funds"), 485 closed-end investment companies, and 6 sponsors of unit investment trusts. Its mutual fund members have assets of about \$6.598 trillion, accounting for approximately 95% of total industry assets, and over 88.6 million individual shareholders.

<sup>2</sup> SEC Release No. 34-45194 (December 27, 2001)

<sup>3</sup> Report of Division of Investment Management, SEC, Protecting Investors: A Half Century of Investment Company Regulation (May 1992).

<sup>4</sup> See Letter from Craig S. Tyle, General Counsel, ICI, to Paul F. Roye, Director, Division of Investment Management, SEC, dated December 10, 1998; Letter from Paul Schott Stevens, General Counsel, ICI, to Barry P. Barbash, Director, Division of Investment Management, SEC, dated July 19, 1995.

<sup>5</sup> Riskless principal transactions in the debt market and other securities that do not have confirmation and reporting requirements that provide sufficient transparency of the execution fees and transaction price are not eligible to rely on the interpretation. See SEC Release No. 34-45194, *supra* note 2, at n.9.