



1984

# North American Securities Administrators Association, Inc.

## REPORT OF THE NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION'S INVESTMENT COMPANIES COMMITTEE TO THE FALL 1984 MEMBERSHIP MEETING

In September, 1983, joint hearings were held by the North American Securities Administrators Association and the Securities and Exchange Commission on the subject of the need for greater uniformity of federal and state securities laws and regulations. A major topic of discussion at the hearing and at later meetings in Williamsburg, Virginia, was the need for greater uniformity with respect to the regulation of diversified open-end investment companies (mutual funds). Following these discussions, Mike Unger appointed this Committee to focus on matters pertaining to such mutual funds. The Committee focus was later expanded to include unit investment trusts (unit trusts).

This Committee has identified particular problems caused by the lack of uniformity in the regulation of mutual funds and unit trusts and has developed recommendations to resolve these problems without diminishing investor protection.

Mutual funds and unit trusts, like other investment companies, are entities which issue their own shares to the public and use the proceeds to acquire a portfolio of securities. Unit trusts are much like mutual funds except they hold a fixed portfolio of securities and therefore do not require the extensive management required by a mutual fund. Most mutual funds are in a continuous

selling process. Most sponsors of unit trusts continuously sell clones of the original trust.

Mutual funds and unit trusts are subject to stringent regulation under the federal securities laws administered by the United States Securities and Exchange Commission.

Mutual fund and unit trust securities, like those of other public issuers, must be registered for sale under the Securities Act of 1933. Unlike other issuers, however, a mutual fund is continuously offering its shares to the public and therefore always must provide a current prospectus to prospective investors. Investment advisers to mutual funds must be registered with the SEC under the Investment Advisers Act of 1940. Sales and distribution practices are subject to the Securities Exchange Act of 1934 and to regulation by both the SEC and the National Association of Securities Dealers, Inc. Most importantly, the mutual fund or unit trust itself, unlike other corporations, must be registered with the SEC under the Investment Company Act of 1940, which establishes a detailed regulatory structure. In addition to requiring periodic reports to fund and trust shareholders and the SEC, the Investment Company Act contains provisions designed to prevent self-dealing, maintain the integrity of fund and trust assets, regulate investment policies, and prevent the payment of excessive fees and charges by the fund or trust and its shareholders. In 1970 the Investment Company Act was amended to increase protections for mutual funds, unit trusts and their shareholders in such areas as management fees and sales charges. Given this pervasive scheme of

federal regulation, it is not surprising that mutual funds have been characterized as the most strictly regulated business entities under the federal securities laws. In the words of former SEC Chairman Ray Garrett, Jr.: "No issuer of securities is subject to more detailed regulation than mutual funds."

In addition, almost all mutual funds and unit trusts qualify as "regulated investment companies" under Subchapter M of the federal Internal Revenue Code in order to avoid the imposition of double taxation on mutual funds, unit trusts and their shareholders. Subchapter M imposes a number of substantive requirements on mutual funds and unit trusts, including diversification of investments and limitations on short-term trading.

Prior to the enactment of the federal Investment Company Act in 1940, a number of individual states adopted regulations governing mutual funds offering shares in those states. In 1939, the National Association of Securities Commissioners (now NASAA) codified these requirements in its "Minimum Uniform Regulations of Investment Trusts." State regulation continued after the enactment of the federal Acts in 1940. NASAA has also remained active in this area. For example, effective January 1, 1953, NASAA adopted a series of regulations pertaining to mutual funds, and in 1978 NASAA's Investment Company Committee recommended that all states eliminate or suspend enforcement of their expense limit rules for mutual funds.

#### Lack of Uniformity

As discussed below, the Committee has found a number of instances in which there is a lack of uniformity between federal and state regulation of mutual

funds and unit trusts and among the requirements imposed by the various states. This lack of uniformity results from a number of factors.

1. Some state requirements which were imposed prior to the enactment of the federal Investment Company Act in 1940 have remained in place, despite the fact that the 1940 Act addressed these same areas.

2. Similarly, some state requirements imposed prior to 1970 have remained in place, despite the fact that in 1970 the federal Act was amended to address these same concerns.

3. Some states have not revised their requirements to take into account new developments in the mutual fund and unit trust industry.

4. Some states have imposed requirements on mutual funds and unit trusts which, while appropriate for other types of issuers, may not be appropriate for mutual funds or unit trusts.

5. Various states have adopted differing procedural requirements relating to mutual funds and unit trusts.

Many specific problems can be rectified by the states without diminishing investor protection. Resolution of some or all of these problems might also permit our members to allocate their staff's time and resources more productively and efficiently.

#### Summary of Identified Problem Areas

The following summarizes six specific problem areas identified to the Committee by the Investment Company Institute and their Committee on State Regulation, and by the Unit Investment Trust Association.

## 1. Expense Limitations

### A. Problem

In 1978, twenty-five states limited the amount of annual expenses which could be paid by mutual funds. In that year, the Investment Companies Committees of both NASAA and the Midwest Securities Commissioners Association issued a report recommending that all states eliminate or suspend enforcement of their expense limits because "not only was there no empirical basis to support the imposition of expense limitations as a protective device for investors, but . . . such limitations are in fact counter-productive from the standpoint of investor protection." Most states responded to the NASAA-MSCA report by eliminating or suspending their expense limitations. Only ten states still impose such requirements. These are Arizona, California, Iowa, Louisiana, Maine, Mississippi, Missouri, New Hampshire, Ohio and Tennessee. An informal survey indicates that a majority of these states do not strictly enforce their requirements. However, so long as one state strictly adheres to an expense limit, it presents a nationwide problem since most mutual funds feel compelled to offer their shares in all states and must meet the most stringent expense limitation imposed by any state.

### B. Recommended Solution

All states should either suspend or repeal their expense limitation rules and policies. Exhibit A (found at the back of this report) is a draft of a Resolution regarding the issue which will be proposed for adoption at the Fall meeting.

## 2. Filing of Sales Literature

### A. Problem

Section 24(b) of the Investment Company Act of 1940 requires that all mutual funds and unit trusts file all sales literature with the SEC within ten days after its use. The vast majority of mutual funds, i. e., those who sell through registered dealers, are also required to make similar filings with the National Association of Securities Dealers, Inc. Thirteen states and Puerto Rico impose somewhat similar requirements on mutual funds. These are Arizona, Connecticut, Illinois, Iowa, Louisiana, Oklahoma, Maine, North Dakota, Texas, Vermont, Virginia and West Virginia. However, these requirements differ from SEC and NASD requirements, and from each other, with respect to the number of copies to be filed, what type of literature is to be filed, and the time of filing. Mutual funds and unit trusts are continually updating or amending their sales literature and advertising which is in almost constant use. There is almost never an objection to the advertising. Requiring pre-clearance causes constant delays and major administrative problems for issuers. The broad range of filing dates used by the states (from ten days prior to use to the tenth day of the month following its use) create unnecessary compliance problems for mutual funds and unit trusts. Many states do not review these filings.

### B. Recommended Solution

In view of the fact that mutual fund and unit trust sales literature is already subject to review by two regulatory bodies, state filing requirements could be eliminated, or a uniform filing requirement could be adopted by all states who require filings. By adopting a ten days after use standards, a

state administrator desiring to do so can closely monitor the fund's advertising and sales literature without causing the fund the hardship of having to prefile, i. e., file proposed advertising. A Resolution dealing with this subject which will be prepared for adoption at the Fall meeting is attached as Exhibit B.

### 3. Registration Form Requirements

#### A. Problem

All jurisdictions except the District of Columbia, Hawaii, Nevada and New Jersey require mutual funds and unit trusts to register their shares prior to sale or make some specific filing. About forty-four states accept the uniform registration forms, but about eighteen states use different forms or impose varying additional requirements which create major administrative problems for mutual funds and unit trusts. There is almost no uniformity in the handling of amendments and renewals.

#### B. Recommended Solution

All states requiring the registration of mutual fund and unit trust shares should require as an application to register securities, only the following:

##### 1. For An Initial Registration

- a. Form U-1 (general application form),
- b. Forms U-2 and U-2A (Consent to Service of Process and Corporate Resolution),
- c. One copy of the federal Form N-1A, without exhibits,
- d. One extra copy of all parts of the prospectus,
- e. A single check for the state's registration and examination fees, and

- f. These documents should be executed by the issuer in the state where the issuer is located and no "local counsel" should be required. Changes would be necessary by those states which now require special forms, special filing requirements or which require extra information (Alabama, California, Colorado, Florida, Georgia, Illinois, Kansas, Maine, Mississippi, New Hampshire, New York, North Carolina, North Dakota, Pennsylvania, Rhode Island, South Carolina, Texas and West Virginia).

2. For Renewals and Amendments

- a. New Form U-1 facing sheet or a letter,
- b. One copy of all parts of most recent prospectus,
- c. One check for additional fees, if any.

A proposed Resolution to be offered for adoption at the Fall meeting is found at Exhibit C.

4. Sales Report Filing Requirements

A. Problem

Twenty-three states currently require mutual funds and unit trusts to file reports of sales of their shares in that state. These are Alaska, Arizona, California, Connecticut, Illinois, Indiana, Iowa, Kansas, Maryland, Michigan, Minnesota, Mississippi, Missouri, New Hampshire, North Dakota, Oklahoma, Pennsylvania, South Dakota, Tennessee, Texas, West Virginia, Wisconsin and Wyoming. These requirements differ with respect to the form to be used and



the timing of the filings, causing major administrative problems for mutual funds and unit trusts. Most states require annual filings, but Arizona and Texas require quarterly reports and Alaska, Illinois, South Dakota and Wyoming require semiannual reports.

B. Recommended Solution

Sales reports should be filed on a uniform form in each state requiring such filing. These reports should be required to be filed annually within sixty days after the end of the registrant's fiscal year. A proposed Resolution to be offered for adoption at the Fall meeting and a proposed form are found as Exhibit D-1 and D-2, respectively.

5. Oversales

A. Problem

"Oversales" are sales of securities by a mutual fund or unit trust in a state in excess of the amount of securities which the fund or trust has registered for sale in that state for that particular registration period. The securities thus sold are considered to be unregistered and the issuer is often required to make a rescission offer. Mutual funds are more prone to oversales than other types of issuers because they are continually offering their shares for sale, making accurate monitoring difficult, especially when the fund is sold through a number of different dealers. Oversales by mutual funds are most often caused by inadvertence, late mails, or computer error, and seldom, if ever, represent an attempt by the issuer to avoid registering all of its shares in that state. Therefore,

requiring a mandatory rescission offer for oversales is an extremely harsh penalty for mutual funds and unit trusts.

B. Recommended Solutions

There are several systems which are currently in effect in various states which lessen the problem of oversales. States should examine their registration system and determine which of the alternatives, or combinations thereof, best provide a solution in their state to oversales by mutual funds and unit trusts:

1. Permit mutual funds and unit trusts to register an indefinite number of shares or pay a flat fee. (Twenty-four jurisdictions do so today. These include California, Connecticut, Florida, Georgia, Illinois, Maine, Maryland, Mississippi, Missouri, New Mexico, North Dakota, Ohio, Oregon, Puerto Rico, Rhode Island, South Carolina, Utah, Vermont, Virginia, Wisconsin and Wyoming. Those states with flat fees are Delaware, Massachusetts and New Hampshire.)
2. Permit mutual funds and unit trusts which have had oversales to amend their registrations to increase the number of shares registered and to pay the balance of registration fees owed for the increased number of shares, while requiring the submission of an explanation for the oversales and pay a modest penalty fee. (Missouri follows this procedure.)
3. Require retroactive payment of registration fees at year-end when the fund or trust files its sales report. (Tennessee follows this procedure.)

4. Permit registered mutual funds and unit trusts to register over-sales by payment of penalty fees. (Texas follows this procedure.)

A Resolution on this issue to be offered for adoption at the Fall meeting is found at Exhibit E.

6. State Substantive Requirements

- A. Problem

Mutual funds and unit trusts are subject to substantive requirements on the federal level. In addition, about eleven states impose substantive requirements on mutual funds and unit trusts. These include California, Indiana, Iowa, Maine, Minnesota, Missouri, New Hampshire, Ohio, Tennessee, Texas and Wisconsin. The state substantive requirements (merit standards) are based primarily on systems of regulation developed independently from the federal scheme of regulation governing mutual funds and unit trusts. Often these states have not updated their regulations to reflect the changing and growing mutual fund and unit trust industries. As a result, state regulations contain provisions, some of which are outdated or duplicative of federal requirements. The Investment Company Act of 1940 contains substantive (merit) standards. The burden on funds and trusts of monitoring and complying with these state regulations is substantial.

- B. Recommended Solution

1. Duplicative provisions should be eliminated. State provisions which are identical or similar to federal provisions seem unnecessary and troublesome. These state provisions are "frozen" in time, mirroring the federal law as of a

certain date. The SEC maintains a large staff which is devoted full-time to updating SEC rules and regulations; no similar function can easily be carried on by the states. Thus, these provisions can rapidly become obsolete.

2. Inappropriate provisions should be eliminated. Numerous state securities laws contain outdated provisions, based on laws drafted prior to 1940, or provisions that were drafted for use in connection with other kinds of issuers.

3. Some special investment restrictions should be eliminated or modified. A good deal of study in this area is still required. This will be a focus of the Committee in the coming year.

Each affected member should decide prior to the Fall meeting whether it is opposed to the proposed Resolutions regarding (1) suspension or elimination of the expense limitation; (2)(a) uniform filing requirements for advertising and sales literature or (b) elimination of the sales literature and advertising filing requirements; (3) uniform forms and procedures for filing original and renewal applications and amendments; (4) uniform sales report filing requirements, and (5) providing a solution for oversales that does not require a rescission offer. The Committee will offer these Resolutions which will require a membership vote on each. The Committee would like to work with any member who is opposed to any of the concepts in whole or in part so that we may identify and hopefully solve the problems prior to the business meeting September 20, 1984.

Please bring this Report and Draft Resolutions to the Fall meeting.

Bob LaNoue	- Member
Henry Lanterman	- Member
Jim Lummanick	- Member
Carl Tyson	- Member
John Wurth	- Member
Richard Latham	- Chairman

NASAA INVESTMENT COMPANIES COMMITTEE  
REGULATORY LIAISON SECTIONRESOLUTION PERTAINING TO EXPENSE LIMITATIONS

WHEREAS, Approximately ten states have rules or policies through which they may impose, as a condition of registration of securities, limits on the amount of expenses a mutual fund may bear, stated as a percentage of its annual average asset value, and

WHEREAS, Information gathered by NASAA does not demonstrate a correlation between a mutual fund's expenses and the profitability to investors of such fund, and

WHEREAS, NASAA does not endorse the imposition of a regulatory standard which does not clearly promote investor protection, now.

THEREFORE, BE IT RESOLVED That NASAA strongly encourages its members with rules or policies imposing an expense limitation on mutual funds as a condition to registration of its securities, to suspend or repeal such rules or policies.

Adopted this 20th day of September, 1984.

NASAA INVESTMENT COMPANIES COMMITTEE  
REGULATORY LIAISON SECTIONRESOLUTION PERTAINING TO FILING OF SALES LITERATURE

WHEREAS, Approximately thirteen member states currently require mutual funds and unit trusts to file sales literature and advertising as part of the securities registration process, and

WHEREAS, The filing requirements in most states are dissimilar as to when such filing must be made and as to how the filing must be made, and

WHEREAS, All mutual funds and unit trusts who register their securities for sale with the Securities and Exchange Commission must file sales literature with that agency within ten days of its use, and

WHEREAS, All securities dealers who are members of the National Association of Securities Dealers and who sell mutual fund or unit trust shares must comply with NASD advertising and sales literature requirements which require that it be filed with them within ten days of its use, and

WHEREAS, NASAA supports the elimination of procedures which are unduly burdensome on applicants seeking to register securities, now

THEREFORE, BE IT RESOLVED That NASAA strongly encourages its members who impose on mutual funds and unit trusts whose securities are registered with the SEC and/or which are sold by securities dealers who are members of the NASD, a requirement that proposed advertising and sales literature be filed, to suspend or repeal their respective laws, rules and policies which re-

quire the filing of proposed sales literature and advertising or, in the alternative, to amend their laws, rules and policies to require that one copy of advertising and sales literature which is required to be filed, be required to be filed within ten days after its use.

Adopted this 20th day of September, 1984.

NASAA INVESTMENT COMPANIES COMMITTEE  
REGULATORY LIAISON SECTIONRESOLUTION PERTAINING TO APPLICATION FORMS

WHEREAS, Approximately forty-four states currently accept applications to register investment companies securities on uniform forms, and

WHEREAS, It would greatly enhance uniformity among the NASAA members if each state were to require only certain specified uniform forms and exhibits, and were to follow uniform procedures with respect to applications for initial securities registration and amendments and renewals to those filings, now

THEREFORE, BE IT RESOLVED That NASAA strongly encourages its members to require only the following as an initial application to register investment companies securities:

- A. Form U-1,
- B. Forms U-2 and U-2A,
- C. One copy of federal Form N-1A, without exhibits,
- D. One extra copy of all parts of the prospectus, and
- E. A single check for the registration and examination fee.
- F. Such documents to be filed by the issuer without the necessity for sponsorship by a broker/dealer resident in the state, or that the applicant be represented by a counsel resident in that state, and



BE IT FURTHER RESOLVED That NASAA strongly encourages its members to require only the following as an application to amend or renew an existing registration:

- A. A facing page of Form U-1, or a letter,
- B. One copy of all parts of the most recent prospectus,
- C. A single check, if additional fees are necessary.

Adopted this 20th day of September, 1984.

NASAA INVESTMENT COMPANIES COMMITTEE  
REGULATORY LIAISON SECTIONRESOLUTION PERTAINING TO SALES REPORTS

WHEREAS, Approximately twenty-three states currently require mutual funds and unit investment trusts that are registered to sell securities to file sales reports reflecting sales of shares made from current registered amounts, and

WHEREAS, Nineteen states have promulgated their own sales-reporting forms which has resulted in considerable disparity among the member states as to the filing date, requirements and procedures which must be followed, and

WHEREAS, A single sales-reporting procedure on a uniform form would dramatically reduce the burden on registrants, now

THEREFORE, BE IT RESOLVED That NASAA strongly encourages its members to examine their current need for a sales report to determine if such a report is any longer necessary, and, if necessary, to require an annual report to be due within sixty days after the end of the registrant's fiscal year, and

BE IT FURTHER RESOLVED That NASAA strongly encourages its members to allow registrants to use a uniform sales report substantially similar to the attached uniform form designated "USR".

Adopted this 20th day of September, 1984.

FILE/PERMIT NO. \_\_\_\_\_

INVESTMENT COMPANY REPORT OF SALES

TO THE STATE OF

\_\_\_\_\_

For the 12 Month Period Beginning \_\_\_\_\_ Ending \_\_\_\_\_

Fund \_\_\_\_\_

Address \_\_\_\_\_

Contact Person \_\_\_\_\_

Phone Number \_\_\_\_\_

BEGINNING BALANCE \$ \_\_\_\_\_

ADDITIONAL AMOUNTS AUTHORIZED DURING THIS PERIOD (if any) \$ \_\_\_\_\_

TOTAL AVAILABLE FOR SALE \$ \_\_\_\_\_

(NET) SALES DURING THE PERIOD \$ \_\_\_\_\_

If the figure given is for the net sales, provide the following information:

SALES DURING THE PERIOD \$ \_\_\_\_\_

REDEMPTIONS DURING THE PERIOD \$ \_\_\_\_\_

ENDING BALANCE \$ \_\_\_\_\_

We certify that the foregoing is a complete report of sales for this Fund during the period specified.

Date: \_\_\_\_\_

(Fund)

By \_\_\_\_\_

(Authorized Signature)

NASAA INVESTMENT COMPANIES COMMITTEE  
REGULATORY LIAISON SECTIONRESOLUTION PERTAINING TO OVERSALES

WHEREAS, Almost all mutual funds are continuously registering shares for sale in most states, and unit trusts offer numerous "clone" funds on a continuous basis in most states, and

WHEREAS, There is no uniform treatment among states of problems created when a mutual fund or unit trust sells in a particular state, more shares than have been registered for sale, and

WHEREAS, NASAA recognizes that oversales are almost always inadvertent, and

WHEREAS, NASAA believes that the necessity for a mutual fund or unit investment trust to make a rescission offer because of oversales is a remedy which is unnecessarily harsh when compared to the transgression, now

THEREFORE, BE IT RESOLVED That NASAA strongly encourages its members to not require rescission offers to be made when oversales are promptly admitted by the registrant and appropriate fees are paid, and

BE IT FURTHER RESOLVED That NASAA strongly encourages its members to amend their laws, rules and procedures pertaining to investment companies to:

1. Permit mutual funds and unit investment trusts to register an indeterminate number of shares, or, in the alternative, pay a single fee for registering an indeterminate amount of shares; or

2. Permit mutual funds and unit investment trusts which make inadvertent oversales to cure the deficiency by amending the registration to register the additional securities with the payment of a fee in addition to the fee otherwise required.

Adopted this 20th day of September, 1984.