


MEMORANDUM

September 9, 1987

TO: Chairman Ruder

FROM: Kathryn B. McGrath, Director 
Division of Investment Management

SUBJECT: September 10 meeting with David Silver
President, Investment Company Institute

I understand from Dave Silver that the ICI's primary point will be that the ability of the Commission to respond to the investment company industry effectively is hampered by our lack of resources. He likely will make a pitch for more Investment Management staff, arguing that investment companies are paying (through registration and other fees) for more "regulatory services" than they are getting. The Commission, in the last two years, spent about 6% of its total budget on investment company matters, and collected about 15% of its fees from investment companies. In dollars, we spent about 1/5 of the amount that we collected from investment companies. The rest of the money probably went to DOD; perhaps they bought a tank or two. I am attaching materials reflecting growth in the number of investment companies and the assets they manage. (Attachment A).

Dave also told my staff that he will raise with you a number of specific issues, open and closed, that have come up over the last few years. The list he gave us follows:

Advertising Proposal.

Last September the Commission proposed rules to standardize investment company performance data. Although built on an ICI proposal to standardize

reporting of yields for income funds, the proposals would go further by requiring all income funds advertising performance to present standardized total return as well as standardized yield information. The ICI continues to prefer its more limited approach to the problems of fund advertising, and believes we should have adopted their more limited proposal long ago. We expect to get a recommendation on the advertising rule to the Commission this fall.

Rule 12b-1.

The Division is reviewing the operation of Rule 12b-1, adopted in 1980. This rule allows fund (shareholder) assets to be used to pay for the cost of selling more fund shares to investors, e.g., advertising costs, sales commissions to brokers at the time of sale and continuing payments to brokers whose customers stay in a fund. While there is disagreement in the industry about the merits of 12b-1, the ICI has adopted the position of the broker-sponsored funds that 12b-1 is necessary and "good" for investors. Huge amounts of money are involved, and the ICI is understandably worried that the staff might recommend that the Commission kill this "cash cow." We are working on proposals to make some changes in the rule and to improve disclosure about these fees. It's taking a terribly long time and I'm

sure the ICI is frustrated. Again, I hope to have something to you late this fall.

Foreign Custody of Investment Company Assets.

Because foreign banks, clearing agencies and securities depositories are not permissible custodians of investment company assets under section 17(f) of the 1940 Act, the Commission adopted rule 17f-5 in 1984 to permit funds, under certain conditions, to maintain foreign securities in the custody of entities overseas, where the securities are traded. Since 1984, there has been significant growth in the number and assets of funds investing principally in foreign securities. The ICI has suggested that the Commission amend rule 17f-5 under the Act to ease some of the conditions. We have reviewed the ICI's suggestions, as well as comments received in response to a letter sent by the Division to members of the International Society of Securities Administrators, and are developing recommendations responding to the suggestions. It is simply a matter of time until we get to this to you.

"As of" Transactions.

We have continuing concern over the industry's treatment of "as of" transactions, i.e., transactions in mutual fund shares that, due to error or back-log, are not processed on the date the order is received, but later are priced "as of" the date of receipt. This

practice can unfairly dilute the value of other investors' shares, particularly when a mutual fund transfer agent falls seriously behind in posting transactions and the situation remains uncorrected. When regional office staff have discovered these problems in inspections, they have normally urged that funds ask the transfer agents responsible to make them whole, if the amounts involved are significant, i.e., more than a penny a share. However, the ICI takes the position that the relationship between a fund and transfer agent is contractual and that the Commission should permit each fund's board of directors to accept losses arising from "as of" transactions as a business risk. We have not objected to this where the losses are minimal. However, the ICI agrees some controls on transfer agents are appropriate, and, as an alternative, has submitted draft rules to the Division of Market Regulation under Section 17A of the Exchange Act to set standards for transfer agents processing fund shares. Market Regulation has them under consideration.

Personal Checks and Redemptions.

In 1975 the Division issued a no-action letter to the ICI permitting funds to hold a redemption request until a shareholder's check used to purchase fund shares had cleared. In 1985 the ICI asked the staff to formally expand the position to permit across-the-board holds,

i.e., without tracking particular checks, for up to 15 days. The statute requires redemptions within 7 days. Given Congressional and Federal Reserve Board efforts to decrease check holds, we believe this is a sensitive issue. Early this year, we advised the ICI of our concerns and the kind of data we thought necessary to consider their proposal. ICI check aging studies have not yet included the data we need.

Mutual Fund Statement of Additional Information.

On June 4, 1985, the ICI recommended that the Commission amend the mutual fund registration form to require registrants to include a designated telephone number for investors to request the SAI. (Of course, there is no reason why an investment company can't do this on its own.) This was in response to a Division request for recommendations to ensure timely delivery of the SAI to investors who ask for it. The Division is to dealing with this problem in technical amendments we are now developing.

Dividend Dates.

The Division has questioned whether a senior security issue arises when there are differences between the date on which dividend payments to dividend reinvesting shareholders are credited and the date on which cash payments of dividends are made to other shareholders. In November 1985, the ICI, in response to a staff request, provided its views that a reasonable time difference

should not constitute a senior security in violation of Section 18. We haven't responded, and I assume he wants an answer.

Proxy Revisions.

On July 1, 1986, the ICI proposed various revisions to the proxy rules under the 1940 and 1934 Acts and the proxy schedule. Revision of the proxy rules is one of the Division's major priorities -- after we finish the advertising rules and a new registration form (Form N-7) for unit investment trusts.

Concentration.

Several years ago the ICI asked the staff to reconsider its positions that (i) mutual funds generally may not reserve freedom of action to concentrate investments at management's discretion and (ii) money market funds may reserve freedom of action to concentrate in certain bank instruments but these investments must be limited to securities of domestic banks. Although the staff considered the desirability of expanding the money market fund position to include savings and loan securities, it tabled revision of the concentration guidelines after the Ohio and Maryland S&L crises. We continue to believe that the staff's general position on concentration is legally sound, and that fund managers should generally tell investors what they plan to do with their money, and try to stick to that.

Investments in equity securities of foreign broker-dealers.

The ICI filed a request that the Commission amend rule 12d3-1 to permit funds to acquire equity securities issued by foreign securities firms. Until rule 12d3-1 was adopted in 1984, funds were flatly prohibited by Section 12(d)(3) from purchasing the securities of a broker-dealer, underwriter or investment adviser. At the time Rule 12d3-1 was proposed, no comments were received that suggested the rule should be extended to foreign securities firms. We agreed to consider the ICI request and noted that funds can continue to obtain individual exemptive orders permitting such acquisitions pending the Division's consideration of the proposed rule amendment. But we told the ICI we couldn't get to this rule soon. The ICI recently submitted a no-action letter to permit funds to acquire equity securities of foreign broker-dealers if they meet the terms of exemptive orders obtained by others. The Division is presently processing this no-action request and probably will say yes.

OTHER ISSUES THAT COULD COME UP.

Investment Company Disclosure and Regulation.

- ° Speed of Processing. Disclosure goals, which are generally met, are to give initial comments on registration statements within 30 days. Although the industry often complains about delays, the Division

has managed to keep up with the growth and usually manages to accommodate registrants' timing needs. Most people tell me they get far faster disclosure review than they did before I arrived, and they're pleased.

- ° Inconsistency of Comments among the Disclosure branches. This has been complained about in the past, and although I believe it has been cured by the Disclosure staff, it may be raised.
- ° Misleading Names under ICA §35(d) and the name "Tax Exempt" for mutual funds investing in municipal bonds that are subject to the alternative minimum tax (AMT). Guidelines to Form N1-A require 80% of such a fund's investment to be in tax exempt securities; we have stated our position that AMT paper should not be included in the 80%. The ICI disagrees, asserting that most investors either aren't subject to the AMT, or don't think of it in the same way as other federal income taxes.
- ° Fee Table Proposal. The ICI reversed its early position against a fee table for investment company expenses and suggested a format in a submission about Rule 12b-1 last summer. They will probably object to that part of the Commission's reproposal, released on August 18, 1987, that differs from their submission, saying there is no need to let investors know the effect of fees on a hypothetical investment.

- ° Proposed Rule 19b-1. We agreed with the ICI that rule amendments were necessary to address the effect of the 1986 Tax Reform Act, which required funds to distribute substantially all their capital gains within the calendar year to avoid imposition of an excise tax. The Commission proposed rule amendments that considered a submission by the ICI, but did not incorporate it verbatim. We are preparing a final version of the amendments that addresses issues raised by the ICI in its comment letter. It should be before you in early October.
- ° Tax Issue - "Gross-up" of Shareholder Income. The Tax Reform Act requires Treasury to adopt rules attributing fund advisory fees to shareholders as income except if they and other miscellaneous expenses exceed the 2% of the tax payer's adjusted gross income. This will mean a shareholder's 1099 may show he received \$100 in income when he got a check for only \$99. The ICI, of course, has opposed this and we understand Treasury is seeking repeal because of the potential for errors in 35 million shareholder tax returns. On this and other aspects of Tax Reform affecting investment companies, we have provided factual information to Treasury and Congress, when asked, generally supporting facts conveyed by the ICI, but have not taken any positions on the tax-policy issues.
- ° Market Emergencies. Section 22(c) and Rule 22(c)(1) require investment companies to sell and redeem shares at the next computed net asset value, determined daily.

Section 22(e) prohibits the suspension of the right of redemption except in certain specified situations, one of which is an emergency during which a fund is unable to dispose of securities owned by it or to fairly value its assets. Under Section 22(e), the Commission determines when an emergency exists, and historically the Commission and staff have been able to deal effectively with bona-fide emergencies on a case-by-case basis. In addition, the staff has provided flexibility to funds in dealing with weather emergencies. Earlier this year, the ICI asked the Division to consider rule proposals to allow a fund to suspend pricing and redemption whenever the fund determines that an emergency exists and fair value cannot be determined for 10% or more of fund assets (i.e., in a "market emergency"). The staff declined to recommend the rules to the Commission, citing the infrequency of actual emergencies and the staff's ability to handle them on a case-by-case basis. We are unwilling to recommend giving total discretion to the industry in this area. Recently, some municipal bond funds have inquired about suspending redemptions when they didn't like the price they could get on a particular day.

- ° NSCC System. The National Securities Clearing Corporation, at the request of the ICI, the NASD and an industry task force of broker-dealers and mutual funds developed

an automated and centralized processing system for order entry, confirmation, registration and settlement of mutual fund orders handled by broker-dealers. Beginning as a test or pilot program in January, 1986, involving five fund groups, the program has now grown to 13 fund group users. This automated, centralized system offers two principal advantages: (i) it encourages a uniformity of data format which facilitates computer-based (tape to tape) transmissions of order instructions between brokers and fund transfer agents and (ii) it places an impartial body operating under proscribed procedures between the selling broker and the fund group. NSCC will, in this regard, effect settlement of transactions on a prescribed schedule basis following transaction date. While the NSCC continues to operate the program on a pilot basis, we anticipate that it will request to have the rules under which it operates made permanent. Industry response to the system has been very favorable.

- ° Captive Insurance Company. In May 1987, the ICI requested no-action and exemptive relief to establish a captive insurance company for investment companies and their affiliates, in order to provide increased coverage at lower cost to its members. The ICI requested no-action if: (1) the proposed captive insurance company did not register under the 1933 Act or 1940 Act; and (2) funds participating in the captive insurance company

did not hold shareholder meetings prior to joining the company. The ICI requested exemptive relief under Section 17(d) of the 1940 Act so that the participation by investment companies and their affiliates would not be deemed to violate prohibitions in Section 17(d) of the Act. The relief was granted on June 9, 1987 by a no-action letter and exemptive order issued under delegated authority.

- ° Unit Investment Trusts. This segment of the industry recently joined the ICI. The Commission has outstanding several major rule and form proposals to streamline UIT registration requirements including an initiative to eliminate on-going audit requirements that is based on an ICI recommendation. But the ICI takes issue with some of the Commission's "improvements" on their suggestions.
- ° Closed-end Funds. The number and size of closed-end funds has increased dramatically in recent years, in part because of investor interest in "country" funds concentrating in the securities markets of individual countries. The ICI will begin to represent the closed-end fund industry this fall.
- ° Exchange Offers. Proposed Rules 11a-3 and 11c-1. Issued last December, these proposals would exempt exchange offers involving mutual funds and unit investment trusts from provisions of Section 11 of the 1940 Act. The

ICI and other commentators recommend that certain provisions be clarified or eliminated. The nature of some comments and our desire to change the rule in response may require a reproposal.

Insurance Products

- ° CREF (You recused yourself, and should tell Dave so if he raises this).
- ° Processing. Because of the complexity of insurance products, staff processing time is longer than for other investment companies.

Inspections

- ° Need for more frequent inspections of both investment companies and investment advisers. The ICI is a strong supporter of our inspection program. It gives members credibility and they find it helpful, as we usually simply ask them to correct problems. See attachment B on Inspection Activity.

Investment Advisers

- ° Adviser Performance - ICI objects to staff position that advisers advertising performance results should compute performance net of advisory fees, and recently filed a rulemaking petition.
- ° Proposed Rule re Disclosure of Material Financial and Disciplinary Information - ICI agreed with tenor of the proposal but objected to the detail required.

- ° Financial Planner Regulation, possibility of an SRO. In the past, the ICI has opposed the concept of self-regulation for investment advisers, but may support the idea of having the NASD take on this role.
- ° Edgar. Generally, the Investment Company Institute and its investment company members are strong supporters of Edgar and the Commission's plan for electronic filing. When the Commission opened the Pilot to investment companies, the ICI helped recruit a volunteer group of investment company sponsors to join the Pilot. The investment company filers have provided a good test of the Edgar system's capabilities and have provided feedback and suggestions that have been helpful in our development of the system. For example, the multiple registrant and reference filing procedures were first implemented to accommodate investment companies. Although some of these filers have expressed concerns about the cost involved in conversion to electronic filing, most prefer electronic to paper filing, and we continue to get inquiries from investment companies about joining the Pilot. Investment companies see development of a way to permit one-stop filing for the SEC and all 50 states as critical to their continued support for Edgar.

- ° Internationalization. In January, 1984, the Commission submitted to Congress a proposal to amend Section 7(d) of the 1940 Act to make it easier for the Commission to permit foreign investment companies to register under the 1940 Act and sell their shares in the U.S. The Commission's memorandum accompanying the proposal comments that Section 7(d) currently presents needless costs and insurmountable barriers to foreign funds seeking access to U.S. markets, with a resulting loss of competition and investment opportunities for U.S. investors. The bill was never introduced in either house of Congress, probably due to ICI opposition, but the ICI has stated recently that it would strongly support a proposal to amend Section 7(d) if the concept of reciprocity was part of the proposal. ICI members are seeking to expand their business overseas, and some foreign regulators are raising the need for reciprocity as a quid pro quo. The staff also is exploring the idea of reciprocity with the Ontario Securities Commission, and has asked the ICI for its help in assembling information.

Attachments

ATTACHMENT A

GROWTH IN THE INVESTMENT MANAGEMENT INDUSTRY

End of Fiscal Year	<u>1980</u>	<u>1981</u>	<u>1982</u>	<u>1983</u>	<u>1984</u>	<u>1985</u>	<u>1986</u>	<u>1987</u>
Investment Companies	1,461	1,574	1,830	2,057	2,210	2,458	2,912	3,300
Assets (\$ Billions)	235	315	315	360	370	465	800	1,200
Investment Advisers	4,580	5,100	5,445	7,043	9,083	11,100	11,000	13,000
Assets (\$ Billions)	440	450	670	780	850	1,200	1,200	3,500

ATTACHMENT B

INVESTMENT COMPANY AND INVESTMENT ADVISER INSPECTION ACTIVITY

	<u>1981</u>	<u>1982</u>	<u>1983</u>	<u>1984</u>	<u>1985</u>	<u>1986</u>	<u>1987</u>
Investment Companies	1461	1574	1830	2057	2210	2458	2912
Inspections Completed	236	355	348	497	567	643	650
Inspections as Percent of Total Registrants	16.16%	22.55%	19.02%	24.16%	25.66%	26.16%	21.98%
Investment Advisers	4580	5100	5445	7043	9083	1100	1100
Inspections Completed	512	710	737	837	1039	1263	1215
Inspections as Percent of Total Registrants	11.18%	13.92%	13.54%	11.88%	11.44%	11.38%	11.05%

As shown in the table, the number of investment company inspections completed annually increased by 175% between 1981 and 1987. This increase was the result of improvements that were made in the way inspections are conducted. The inspection staff remained fairly constant during this time. In 1984 we inspected about 25% of the industry. However, because of growth in the number of companies since then, the percentage coverage will drop to about 22% in 1987.

Inspections of advisers increased by 71% between 1981 and 1987, also as a result of improvements in the procedures used to conduct inspections. In 1982 we inspected about 14% of all advisers. Because of rapid growth in the number of registered advisers since then, the percentage inspected in 1987 will drop to about 11%.