Protecting Investors: A Half Century of Investment Company Regulation

Division of Investment Management
United States Securities and Exchange Commission

May 1992

This is a report of the Division of Investment Management. The Commission has expressed no view regarding the analysis, findings, or conclusions herein.

Division of Investment Management
United States Securities and Exchange Commission
450 Fifth St. N.W., Washington, D.C. 20549

THE CHAIRMAN

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON. D.C. 20549

May 1,1992

When the Investment Company Act came into effect just over a half century ago, only **436** entities holding slightly more than $2 billion in assets were covered by the new law. At the outset, there were fewer than **300,000** accounts in the newly registered "investment companies".

During the intervening years, investment companies have grown enormously in number, size and variety. Today, more than **3,500** investment companies in the United States hold over $1.5 *trillion* in assets on behalf of over **68** million accounts. To put that in perspective, the assets of these investment companies are approximately 50% greater than the total value of ***all*** the stocks traded in London, one of the world's largest capital markets.

Without government subsidies or taxpayer credit, investment companies have operated with remarkable safety and provided capital to meet the needs of a growing economy. The most common type of investment company, the open end "mutual fund," has become the vehicle for professional management of the current investments and retirement savings **of** millions of Americans.

The Investment Company Act provides investors with specific protections against self-dealing, conflicts of interest, misappropriation of funds, and overreaching with respect to fees, expenses and undisclosed **risks** of many types. The SEC has the important **job** of policing these and other requirements of the law.

While regulation to protect investors is vital to public confidence, overly broad regulation can limit the choices of investors, and unnecessary regulatory costs are ultimately passed through to investors. Therefore, two years ago I asked the Division of Investment Management to conduct a thorough study of our system. In particular, I asked them to look at areas where the law should be more flexible, or where regulatory costs could be reduced, without sacrificing the quality of investor protection. After a half century of market change, it is appropriate to consider where we can update and improve the overall system.

The resulting report recommends a number of proposals for constructive evolution in this vital law. My fellow Commissioners and I look forward to reviewing these recommendations carefully. It is my hope that they will enhance innovation and efficiency in the capital markets while maintaining the highest quality of investor protection and market integrity.

Richard C. Breeden

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON. D.C. 20549

DIVISION OF
INVESTMENT MANAGEMENT

May 1,1992

Dear Mr. Chairman:

I am pleased to submit the Division of Investment Management's report on investment company regulation. Two years ago, with the approach of the fiftieth anniversary of the Investment Company Act of **1940,** you asked the Division to take a fresh look at the regulation of investment companies to determine whether existing regulation imposed unnecessary constraints on investment companies or the provision of other financial services and whether there were gaps in investor protection.

The Division has devoted considerable effort to the report. In addition to a full-time staff of ten, virtually everyone in the Division has contributed. I especially would like to note the indispensable contribution of Matthew A. Chambers, whose leadership has guided the review from its inception. Special commendation also should go to Nancy Moms, who served as the deputy director of the project until late last year, and to Karen Skidmore and Diane Blizzard, whose office largely has been responsible for completing the work. We received substantial assistance from other Commission divisions and offices and from Mary Ann Gadziala, Counsel to the Chairman.

Without preconceived notions, we have sought the opinions of investor groups, academic researchers, the private bar, and the investment company, investment advisory, banking, pension, insurance, and brokerage industries. We have consulted with other government offices. We received and analyzed over two hundred comments and investigated the operations and dimensions of the financial markets. Research info the Act's history complemented our fact-finding efforts.

We have concluded that the regulatory system crafted half a century ago has worn well, providing the framework for the development of a dynamic industry. In some respects, however, regulation has not kept pace with the changes in financial markets and may prevent investment companies from offering flexible, efficient, and competitive vehicles for investing in the financial markets. It also may distort the activities of companies that should not fall within the Act.

We do not recommend changes to the fundamental protections that have worked so well since 1940. At the same time, we do recommend changes that we believe will promote investor protection, encourage innovation and flexibility, and facilitate competition and capital formation by removing unnecessary regulation. We believe that these changes should allow the financial markets to continue to provide United States investors with a broad range of sound and flexible investment options.

Sincerely,

Marianne K. Smythe

Marianne K. Smythe
Director

ACKNOWLEDGMENTS

In the preparation of this report, the Division had the able assistance of many members of the Commission staff. The Division Director at the inception of the study was Kathryn B. McGrath. The Division's original study team consisted of Matthew A. Chambers, Associate Director, Nancy Morris, Deputy Chief Counsel, Karen L. Skidmore, Assistant Director, Paul Goldman, Chief Financial Analyst, Diane C. Blizzard, Deputy Chief of Office, Wendell Faria, Deputy Chief of Office, Regina Hamilton, Branch Chief, Ann Glickman, Special Counsel, Rochelle Kauffman, Senior Counsel, Stuart Horwich, Attorney, Maura Murphy, Attorney, and Muriel Edwards, Secretary.

Many other members of the Division contributed to the drafting or editing of various sections, including Thomas S. Harman, Associate Director (Chief Counsel), Clifford Kirsch, Assistant Director, Robert Plaze, Assistant Director, Heidi Stam, Associate Chief Counsel, Kenneth J. Berman, Deputy Chief of Office, Angela Goelzer, Special Counsel to the Director, L. Bryce Stovell, Senior Special Counsel, Robert G. Bagnall, Special Counsel, Thomas Sheehan, Special Counsel, Lawrence Stoller, Special Counsel, Eva Carney, Senior Counsel, Roseanne Harford, Attorney, Richard Jackson, Attorney, Elizabeth Krentzman, Attorney, L. Hope Lewis, Attorney, Edward Rubenstein, Attorney, Gregory Jaffray, Compliance Examiner, Evelyn Malone, Legal Technician, and Michele Bartley, Secretary.

Many members of the Division also made significant contributions in reviewing and commenting on the report, including Gene A. Gohlke, Associate Director, Mary S. Podesta, Associate Director, Carolyn Lewis, Assistant Director, R. Michael Parker, Assistant Director, Jeremy N. Rubenstein, Assistant Director, Douglas Scheidt, Assistant Director, Sid Cimmet, Senior Special Counsel, Lawrence A. Friend, Chief Accountant, Stanley B. Judd, Senior Special Counsel, Michael Wible, Special Counsel, Yvonne Hunold, Senior Counsel, Thomas E. Bisset, Attorney, Marc Duffy, Attorney, Wendy Friedlander, Attorney, Patrice Pitts, Attorney, Nicholas Thomas, Attorney, Courtney Thornton, Attorney, Julia Ulstrup, Attorney, and Barbara Whisler, Attorney.

TABLE OF CONTENTS

PROTECTING INVESTORS: A HALF CENTURY OF INVESTMENT COMPANY REGULATION

EXECUTIVE SUMMARY .... *xvii*

PART I. THE SCOPE OF THE INVESTMENT COMPANY ACT

Chapter 1. The Treatment of Structured Finance under the Investment Company Act 1

Chapter 2. Private Investment Company Exceptions 103

Chapter 3. Pooled Investment Vehicles for Employee Benefit Plan Assets 119

PART II. REMOVING BARRIERS TO CROSS-BORDER SALES OF INVESTMENT MANAGEMENT SERVICES

Chapter 4. Internationalization and Investment Companies 185

Chapter 5. The Reach of the Investment Advisers Act of 1940 ... 221

Chapter 6. Performance Based Advisory Compensation 237

PART III. REGULATION OF INVESTMENT COMPANIES

Chapter 7. Investment Company Governance 251

Chapter 8. The Sale of Open-End Investment Company Shares .. 291

Chapter 9. Investment Company Advertising 347

Chapter 10. Variable Insurance 373

Chapter 11. Repurchases and Redemptions of Investment Company Shares 421

Chapter 12. Affiliated Transactions 473

Chapter 13. Procedures for Exemptive Orders 503

CHAPTER 1

THE TREATMENT OF STRUCTURED FINANCE UNDER THE INVESTMENT COMPANY ACT

I. INTRODUCTION AND SUMMARY OF RECOMMENDATIONS 1

II. OVERVIEW OF STRUCTURED FINANCE 5
- A. The Structured Finance Market 5
- B. Sponsors of Structured Financings 15
- C. Purchasers of Structured Financings 20
- D. Expectations for the Future 24

III. THE SECURITIZATION PROCESS 25
- A. The Components of a Structured Financing 26
- B. The Role of the Rating Agencies 49
- C. Unrated Transactions 63

IV. THE INVESTMENT COMPANY ACT AND STRUCTURED FINANCE 66
- A. Applicability of the Act 66
- B. Effects of the Regulatory Structure 76

V. THE REFORM OF THE TREATMENT OF STRUCTURED FINANCE 76
- A. The Potential for Abuse in Structured Financings 77
- B. The Lack of Abuse in Structured Financings 81
- C. Recommendation — An Exemptive Rule 83
- D. Other Options Considered 95
- E. Section 3(c)(5) 98

VI. CONCLUSION 101

CHAPTER 2

PRIVATE INVESTMENT COMPANY EXCEPTIONS

I. INTRODUCTION AND SUMMARY 103

II. THE PRIVATE INVESTMENT COMPANY EXCEPTION 105

III. A QUALIFIED PURCHASER EXCEPTION 110

IV. OTHER OPTIONS CONSIDERED 114

V. CONCLUSION 116

Appendix2-A 117

CHAPTER 3

POOLED INVESTMENT VEHICLES FOR EMPLOYEE BENEFIT PLAN ASSETS

I. INTRODUCTION AND SUMMARY OF RECOMMENDATIONS 119

II. TREATMENT OF POOLED INVESTMENT VEHICLES UNDER THE FEDERAL SECURITIES LAWS 123
A. Historical Treatment of Bank Collective Trust Funds 123
B. Historical Treatment of Insurance Company Separate Accounts 128
C. Current Securities Laws Exemptions for Pooled Investment Vehicles 131

III. RECENT DEVELOPMENTS IN THE EMPLOYEE BENEFIT PLAN INDUSTRY 136
A. Increase in Number of Defined Contribution Plans 136
B. Growth of 401(k) Plans 139
C. Growth in Defined Contribution Plan Assets 140
D. Competition Among Mutual Funds. Banks. and Insurance Companies 143

IV. INFORMATION PROVIDED TO INVESTORS 144
A. Comparison of Disclosure and Reporting Requirements 145
B. Recommendations for Reform 151

V. SUBSTANTIVE REGULATION OF POOLED INVESTMENT VEHICLES 153
A. Fiduciary Standards 153
B. Prohibitions Against Self-Dealing: Investment Company Act. ERISA. and Regulation 9 157
C. Fund Management 173
D. Valuation and Redemption 175
E. Advertising 176
F. Diversification 177
G. Liquidity 178

VI. CONCLUSION 178

Appendix3-A 182

CHAPTER 4

INTERNATIONALIZATION AND INVESTMENT COMPANIES

I. INTRODUCTION AND SUMMARY OF RECOMMENDATIONS 185

II. BACKGROUND — COMMISSION EXPERIENCE WITH SECTION 7(d) 191
- A. Early Canadian Applications and Rule 7d-1 192
- B. Foreign Portfolio Sales Corporation Act of 1973 193
- C. The 1975 Guidelines 194
- D. The Union-Investment Application 195
- E. The "Mirror Funds" Release 196
- F. The Foreign Investment Company Amendments Act of 1984 198
- G. Section 7(d) and Private Offerings 200

III. DISCUSSION — REMOVING UNNECESSARY BARRIERS TO CROSS-BORDER SALES 202
- A. Harmonization 202
- B. Treaties 204
- C Recommendation — Amendment of Section 7(d) 205

IV. OTHER IMPEDIMENTS TO CROSS-BORDER SALES 214
- A. United States Tax Law 215
- B. State "Blue Sky" Laws 216

V. CONCLUSION 217

Appendix 4-A 218

CHAPTER 5

THE REACH OF THE INVESTMENT ADVISERS ACT OF 1940

I. INTRODUCTION AND SUMMARY OF RECOMMENDATIONS 221

II. THE REACH OF THE INVESTMENT ADVISERS ACT — THE CURRENT APPROACH 223

III. A CONDUCT AND EFFECTS APPLICATION OF THE INVESTMENT ADVISERS ACT 227
- A. The Statute's Jurisdictional Reach 227
- B. Policy Considerations Favoring a New Approach 228
- C. Access to **Books** and Records and Personnel 230

D. Implications of a New Approach 230
E. Other Alternatives 234

IV. CONCLUSION 236

CHAPTER 6

PERFORMANCE BASED ADVISORY COMPENSATION

I. INTRODUCTION AND SUMMARY OF RECOMMENDATIONS 237

II. AN OVERVIEW OF THE PERFORMANCE FEE PROHIBITION 241

III. DISCUSSION 245
A. Financially Sophisticated Clients 246
B. Foreign Clients 246

IV. RECOMMENDATIONS 247

Appendix6-A 250

CHAPTER 7

INVESTMENT COMPANY GOVERNANCE

I. INTRODUCTION AND SUMMARY OF RECOMMENDATIONS 251

II. CONFLICTS OF INTEREST AND INVESTMENT COMPANY GOVERNANCE UNDER THE ACT 255
A. The Role of the Board of Directors 255
B. The Role of Shareholders 260

III. THE DEBATE OVER THE CURRENT GOVERNANCE SYSTEM AND RECOMMENDATIONS FOR REFORM 263
A. The Debate over the Appropriate Role for Directors 264
B. Recommended Reforms of the Role of Directors 266
C. The Debate over Investment Company Shareholder Voting . 272
D. Recommended Reforms of Investment Company Shareholder Voting 274

IV. ALTERNATIVE GOVERNANCE ARRANGEMENTS 282
A. The Original Unitary Investment Fund Proposal 283
B. Investor Protection Issues 284

C. Cost Considerations 286
D. The Impact of the UIF on Internationalization 287
E. Recommendations Concerning the UIF 288

V. CONCLUSION 289

CHAPTER 8

THE SALE OF OPEN-END INVESTMENT COMPANY SHARES

I. INTRODUCTION AND SUMMARY OF RECOMMENDATIONS 291

II. SALES LOADS AND RETAIL PRICE MAINTENANCE 298
A. The Purposes of Section 22(d) 299
B. Commission Action under Section 22(d) 303
C. Amendment of Section 22(d) to End Mandatory Retail Price Maintenance 307
D. Other Options Considered 314

III. SPONSORS OPTIONS FOR DISTRIBUTION FINANCING 315
A. The Treatment of Fees and Distribution Charges under the Act 315
B. Administrative Action Since 1940 320
C. Proposed NASD Regulation of Rule 12b-1 Fees 325
D. Limited Amendments to Rule 12b-1 326
E. Adoption of Rule 6c-10 328
F. Multiple Class Exemptive Rule 330

IV. THE UNIFIED FEE INVESTMENT COMPANY AN ALTERNATIVE 332
A. Rationale for the Unified Fee Investment Company 334
B. Operation of a Unified Fee Investment Company 338
C. Investor Protection Issues **344**

V. CONCLUSION 345

Appendix 8-A 346

CHAPTER 9

INVESTMENT COMPANY ADVERTISING

I. INTRODUCTION AND SUMMARY OF RECOMMENDATIONS 347

II. BACKGROUND 352
A. Application of the Securities Act and Rules to Investment Company Advertising 352
B. The Interplay of Rules 482 and 134 360

III. RECOMMENDATIONS 361
A. "Investment Company Advertising Prospectuses" 361
B. "Off-the-Page" Advertisements 363

IV. OTHER OPTIONS CONSIDERED 369
A. Requiring Prior Delivery of Mutual Fund Prospectuses 369
B. Eliminating Liability under Section 12(2) 369

V. CONCLUSION 370

Appendix 9-A 371

CHAPTER 10

VARIABLE INSURANCE

I. INTRODUCTION AND SUMMARY 373

II. VARIABLE INSURANCE PRODUCTS UNDER THE FEDERAL SECURITIES LAWS 378
A. Variable Annuities 378
B. Variable Life Insurance 379
C. The Introduction of Variable Products 380
D. Periodic Payment Plans 382
E. Application of Sections 26 and 27 to Variable Insurance Products 384

III. PROBLEMS WITH THE CURRENT REGULATORY FRAMEWORK 390
A. The Nature of the Products and Sponsors 390
B. The Investment Charge – Insurance Charge Dilemma 394
C. Problems With Variable Life Insurance – Industry Concerns 395
D. Problems with Variable Annuities -- How Much Is the "Insurance" Worth? 400

IV. RECOMMENDATION 402
A. Statutory Amendments 403
B. Disclosure Proposals 408
C. Effects 410

V. CONCLUSION 417

Appendix 10-A 418

CHAPTER 11

REPURCHASES AND REDEMPTIONS OF INVESTMENT COMPANY SHARES

I. INTRODUCTION AND SUMMARY OF RECOMMENDATIONS 421

II. BACKGROUND 425
A. The Treatment of Open-End and Closed-End Investment Companies Under the Act: The Historical Context 425
B. The Re-Emergence of Closed-End Companies and the Problem of Discounts 432
C. Methods For Reducing Discounts 436
D. Closed-End Tender Offers 439

III. RECOMMENDATIONS 442
A. Repurchase Offers by Closed-End Companies 442
B. Limited Redemption Investment Companies 456
C. Portfolio Liquidity 463
D. Definition of Redeemable Security 466

IV. CONCLUSION 470

Appendix 11-A 471

CHAPTER 12

AFFILIATED TRANSACTIONS

I. INTRODUCTION AND SUMMARY OF RECOMMENDATIONS 473

II. CURRENT REGULATION OF AFFILIATED TRANSACTIONS UNDER THE INVESTMENT COMPANY ACT 474
A. Investment Companies 475
B. Business Development Companies 481

III. OPTIONS FOR REFORM AND RECOMMENDATIONS 482
A. Section 17(a) and Riskless Principal Transactions 485
B. Section 17(d) 488

C. Section 10(f) and Rule 10f-3 .... **499**

IV. CONCLUSION **500**

CHAPTER 13

PROCEDURES FOR EXEMPTIVE ORDERS

I. INTRODUCTION AND SUMMARY OF RECOMMENDATIONS **503**

II. BACKGROUND **506**
A. The Historical Use of Section 6(c) **506**
B. Current Procedures for Obtaining Exemptive Relief under Section 6(c) **508**

III. RECOMMENDATIONS TO EXPEDITE REVIEW OF EXEMPTIVE APPLICATIONS **509**
A. Expedited Procedures for Applications Based on Precedent . 510
B. Amendments to the Division's Delegated Authority **514**

IV. OTHER OPTIONS CONSIDERED **515**
A. Automatic Effectiveness for All Applications Absent Commission Action **515**
B. Dispensing with Prior Notice for Routine Applications **518**
C. Substantive Changes to Section 6(c) **518**
D. Increased Use of Rulemaking Authority **521**

V. CONCLUSION **522**

Appendix 13-A **523**

FIGURES AND TABLES

Figure ES-1 Growth of Management Investment Company Assets **1940-1990** . . . . . *xix*

Figure **1-1** Comparative Data Reflecting Growth of Structured Finance in the United States **1986-1991** **3**

Figure **1-2** Mortgage-Backed Securities Issued in the United States **1986-1991** **6**

Figure **1-3** Non-Mortgage Asset-Backed Securities Issued in the United States **1986-1991** **12**

Figure 1-4 Total Issuance of Non-Mortgage Asset-Backed Securities by Collateral Type **14**

Figure 1-5 Structured Financing Components **26**

Figure **1-6** Financing Backed by Credit Card Accounts Receivable **42**

Figure **1-7** A Master Trust Structure **47**

Figure **3-1** Total Number of Pension Plans in **1988** **137**

Figure **3-2** Growing of Defined Contribution Plans **138**

Figure **3-3** Pension Plan Assets by Type of Plan **1975-88** **141**

Figure **3-4** Comparison of Pension Plan Assets **1981** vs. **1988** **142**

Figure **3-5** **1988** Pension Plan Assets -- Small Plans **143**

Table **3-1** Total Pensions Plan Assets (billions) in Pooled Vehicles, **1990** **144**

Table **3-2** Summary of Status Quo and Recommendations 180

Figure **10-1** Estimate of Annualized New Premium Market Share by Product **376**

Figure **11-1** Premiums and Discounts from NAV for IPOs of Closed-End Funds **435**

Figure **12-1** Upstream Affiliations **476**

EXECUTIVE SUMMARY

In the half century since the enactment of the Investment Company Act of 1940, tremendous growth and structural change have taken place in the financial markets, including the investment company industry. In light of this growth and change, the Chairman of the Securities and Exchange Commission established a task force composed of members of the Division of Investment Management to reexamine the manner in which investment companies and other pooled securities vehicles are regulated.

The modern investment company industry had its genesis in the 1920's when legal impediments 'to one corporation holding the stock of another had fallen. As businesses prospered and common stocks reached record highs, investors of modest means sought to participate in the stock market. Established brokers, investment bankers, and other members of the financial community began actively to promote the investment company concept and to distribute investment company securities.

While the concept itself -- the pooling of funds to provide for diversification, economies of scale, and professional management -- had and still has obvious merit, the early rapid growth of the industry came, in large measure, at the expense of the investing public. Frequently, investment company assets were used by unscrupulous sponsors to further their own business interests. Failures to observe principles of fiduciary duty were widespread, and, as a consequence, holders of investment company securities, including the small, unsophisticated investors for whom the investment company product was so attractive, lost large sums of money.

By the mid-1930's, the problems of the unregulated investment company industry were such that Congress recognized the need to take action. In 1935, Congress directed the Commission to study the fledgling investment company industry and report its findings. Between 1938 and 1940, the Commission transmitted to Congress an exhaustive report on the investment company industry. The report, commonly known as the "Investment Trust Study," laid the foundation for the Investment Company Act. Following several preliminary bills, the legislation that was finally enacted in 1940 was the product of cooperative negotiations between representatives of the Commission and of the investment company industry.

The Investment Company Act reflects a congressional recognition that substantive protections beyond the disclosure requirements of the Securities Act of 1933 and the Securities Exchange Act of 1934 were needed because of the unique character of investment companies and their role in channeling savings into the national economy. As Congress observed in section 1 of the Investment Company Act, "[investment] companies are media for the investment in the

national economy of a substantial part of the national savings and may have a vital effect upon the flow of such savings into the capital markets . . . ."

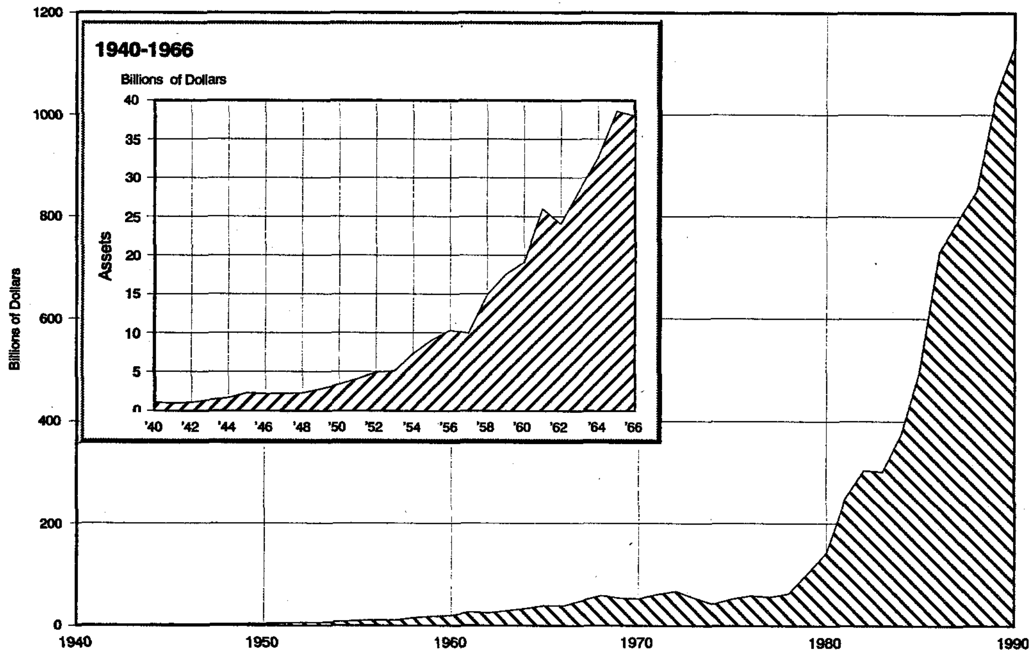
The Investment Company Act establishes a comprehensive federal regulatory framework for investment companies. Regulation of investment companies is designed to:

- -- prevent insiders from managing the companies to their benefit and to the detriment of public investors;
- -- prevent the issuance of securities having inequitable or discriminatory provisions;
- -- prevent the management of investment companies by irresponsible persons;
- -- prevent the use of unsound or misleading methods of computing earnings and asset value;
- -- prevent changes in the character of investment companies without the consent of investors;
- -- prevent investment companies from engaging in excessive leveraging; and, finally,
- -- ensure the disclosure of full and accurate information about the companies and their sponsors.

To accomplish these ends, the Investment Company Act requires the safekeeping and proper valuation of fund assets, restricts greatly transactions with affiliates, limits leveraging, and imposes governance requirements as a check on fund management.

Since 1940 and particularly in the last decade, the investment company industry has grown rapidly. In 1940, the industry held only about two billion dollars in assets, including 105 registered *management* investment companies holding slightly more than one billion dollars in assets. Today, the industry serves as one of the nation's largest financial intermediaries, with more than 3,500 investment companies, and holding over **$1.3** trillion in assets as of the end of 1991. Approximately twenty-five percent of American households invest in investment companies -- either directly, or indirectly through pension funds and similar vehicles.

FIGURE ES-1
Growth of Management Investment Company Assets 1940 - 1990



Source: Investment Company Institute, Wiesenberger Financial Services & Lipper Analytical Services

As the industry has grown, its composition also has changed greatly. In **1940,** the dominant form of management investment company was the closed-end company. Open-end companies had only recently been popularized and had assets whose value was approximately only two-thirds of the value of closed-end companies. Unit investment trusts also were very popular.

In contrast, by **1966,** the open-end segment had grown dramatically and accounted **for** eighty-two percent of industry assets. Today the investment company industry continues to be dominated by the open-end companies, or mutual funds, as they are more commonly known. Such funds currently account for ninety-five percent of industry assets. **A** particular form of open-end company, the money market fund, which did not exist until the late 1970's, now accounts for forty-one percent of the industry's assets.

Increasingly, mutual funds are organized in investment company "complexes," *i.e.,* large groups of mutual funds associated with common advisers or underwriters, typically with liberal exchange privileges among the funds. The one hundred largest mutual fund complexes account for eighty-five percent of total investment company assets.

In spite of this dramatic growth and the concomitant changes in the character of the industry, the Investment Company Act has been amended significantly only once, in 1970. That legislation followed two studies of investment company operations: the Wharton School of Finance's "A Study of Mutual Funds," published in 1962, and the Commission's "Report on the Public Policy Implications of Investment Company Growth," published in 1966. The 1970 amendments added a number of new provisions to provide additional safeguards and protections for public investors. Most significantly, the amendments enhanced the effectiveness of boards of directors as checks on management by strengthening the independence of boards and increasing their role. In addition, the amendments added new provisions restricting sales charges and fund expenses.

In recent years, continued industry growth has been fueled in large part by dramatic changes in the financial marketplace. Institutional demand for collective investment products accounts for a significant portion of that growth. When the Investment Company Act was passed, few, if any, institutional investors invested in investment companies. Institutional assets, which accounted for only eleven percent of investment company assets in 1970, now account for over twenty-five percent of total investment company assets.

In addition, in recent years, an international market for professional asset management has emerged. Investment companies have proved to be attractive vehicles for investors who wish to invest in diversified portfolios of foreign securities. Internationalization of the securities markets also has sparked interest in eliminating barriers to cross-border sales of investment company services.

Marketplace innovations also have led to a host of new pooled securities products that either were not anticipated or whose significance was not fully appreciated when the Investment Company Act was passed or in 1970. Many of these products are constrained by the framework of a statute that originally was designed to deal with only those limited forms of pooled investment vehicles that existed in the marketplace in the 1930's.

For example, a relatively new financial technique called structured finance or securitization is revolutionizing corporate finance, enabling companies to borrow at low cost while providing investors with high quality debt insulated from the credit risk of the company. This technique has gained widespread acceptance. In fact, structured finance volume now constitutes more than half of all United States corporate bond new issue volume. This technique was not anticipated when the Investment Company Act was enacted. Thus, some but not all structured financings fall within the Act's definition of investment company but, as a practical matter, those offerings that fall within the definition of investment company cannot operate as registered investment companies within the regulatory framework of the Act as currently written.

Another example of an unanticipated development is the emergence of defined contribution retirement plans. These plans give individuals a far greater say and responsibility in the investment of their retirement savings than do defined benefit plans and are changing the way in which millions of Americans provide for post-retirement benefits. Increasingly, retirement plans are funded with employees' own contributions and employees choose among a number of funding vehicles, including registered investment companies, bank collective funds, and insurance separate accounts. The employees, of course, bear the risk of their choices. Today, almost forty percent of all private pension plan assets are held in defined contribution plans, and present trends suggest that this number will increase substantially by the end of the century.

To compete more effectively with other financial intermediaries, insurance companies have developed variable insurance contracts. These contracts, hybrids of insurance and investment, were not contemplated by the original drafters of the Investment Company Act, nor were they in widespread use in 1970. Consequently, treatment of variable insurance contracts under the Investment Company Act presents a number of regulatory and practical problems.

To evaluate the need for modernization of the regulation of pooled investment vehicles, the Division identified a number of significant issues that appeared to merit reexamination. The Commission published a concept release, Investment Company Act Release No. 17534 (June 15, 1990), to seek public comment on these issues and any other issues commenters believed significant. In response, the Commission received over 200 comment letters, many of which provided detailed analyses of significant regulatory issues and suggested specific regulatory or legislative solutions. In addition, the Division met with representatives of numerous groups, including investor groups, mutual fund sponsors, mutual fund directors, securities dealers, banks, insurance companies, rating agencies, trade associations, and state, federal, and foreign regulators. Finally, the Division reexamined the historical basis for the current regulatory approach, including legislative and administrative history and prior Commission studies.

The many technological and innovative changes in financial markets since 1940 and even since 1970 have compelled this review of the Investment Company Act and are reflected in the conclusions and recommendations of this report. The recommendations are aimed at achieving three critical objectives:

-- maintaining and improving the current level of investor protection;

-- facilitating competition and capital formation by removing barriers; and

-- encouraging innovation.

Our recommendations leave unchanged the fundamental principles underlying the Investment Company Act. Their soundness is demonstrated by the successful and safe operation of investment companies. Indeed, those principles are partially responsible for the remarkable success of the industry. Of course, no amount of regulation can prevent unsuccessful management of investment companies or losses on investments. It can, however, limit self-dealing, undue risks, and imprudent practices, as well as promote informed investor choice.

The Division's reexamination of the Investment Company Act in light of the financial markets of the 1990's addressed a number of specific topics, which fall into three broad categories:

-- The appropriate scope of the Act; that is, its applicability to various pooled investment vehicles that may fall within the definition of investment company or may resemble traditional investment companies.

-- How best to remove unnecessary barriers to cross-border sales of investment management services.

-- The regulation of investment company operations under the Act and the other federal securities laws.

Our key recommendations are discussed below.

The Scope of the Investment Company Act

The Treatment of Structured Finance under the Investment Company Act. In the last decade, the structured finance industry has become a major facet of American financial markets. Since its origination in the 1970's with the securitization of residential mortgages, modern structured finance has evolved to include securities backed by credit card receivables, automobile loans, corporate bonds, and other financial assets.

Under current law, structured financings literally fall within the Investment Company Act's definition of investment company because they both hold and issue securities. As a practical matter, structured financings cannot register as investment companies because they cannot operate under the Act's provisions. Some structured financings have not been regulated under the Act based on statutory exceptions that were intended for very different businesses. Other financings, primarily involving mortgage products, have received exemptions by Commission order. Financings that are unable to rely on an exception or obtain an exemptive

order are sold offshore or in private placements to not more than one hundred investors. Thus, today the Act distorts the operation and growth of the structured finance market by enforcing distinctions that do not reflect economic reality.

In light of these distinctions between structured financings and traditional investment companies and the virtually abuse-free record of structured financings, the Division recommends that:

> The Commission should adopt a rule exempting structured financings from the Investment Company Act, subject to requirements that would address the potential investor protection concerns presented by structured financings. The requirements y-- essentially those imposed today by the marketplace -- should restrict the degree of "management" of exempt financings, prohibit the issuance of redeemable securities, require ratings in the top two investment grades for all publicly-issued securities, and mandate independent trustees.

The adoption of the rule is intended to remove the artificial constraints that the Act now imposes on the market, while addressing investor protection concerns that may be raised by structured finance offerings.

Private Investment Companv Exceptions. The Investment Company Act excepts from the definition of "investment company" any issuer whose securities are owned by not more than 100 persons and that is not making and does not presently propose to make a public offering. This "private investment company" exception is used by a wide variety of issuers, including small groups of ordinary investors such as investment clubs and pools of Sophisticated institutional investors. For investment companies whose shares are held by less sophisticated investors, the 100 investor limit reasonably reflects the point at which federal regulatory concerns are raised. For funds that sell exclusively to sophisticated investors, however, the 100 investor limit is an unnecessary constraint not supported by sufficient public policy concerns. In light of these factors, the Division recommends that:

> The Investment Company Act should be amended to add a new exception for investment companies whose securities are owned exclusively by such "qualified purchasers" as designated in Commission rulemaking.

Section 3(c)(1) should be amended to simplify the existing shareholder attribution provision to facilitate investments in the excepted issuers.

The Act should be amended to make both private investment companies and the new qualified purchaser pools subject to the restrictions in section 12(d)(1) governing purchases of securities of registered investment companies.

The pyramiding restrictions in section 12(d)(1) thus would apply to all issuers relying on the new "qualified purchaser" exception and all issuers relying on section 3(c)(1), but only with respect to investments in registered investment companies. Investments in the proposed qualified purchaser pools and section 3(c)(1) companies by registered investment companies would not be limited under section 12(d)(1). While protecting the public shareholders of registered investment companies, the amendment would facilitate registered investment company participation in venture capital funds. In addition, the Division has concluded that the existing shareholder attribution provision in section 3(c)(1) is overly broad. By simplifying the provision, the amendment would ease compliance problems without lessening investor protection.

Pooled Investment Vehicles for Employee Benefit Plan Assets. Bank collective funds and insurance company separate accounts that hold assets of employee benefit plans are exempt from the registration requirements of the federal securities laws. Thus, these vehicles are not regulated as investment companies, even though they are similar functionally and structurally to investment companies; and they do not provide plan participants with disclosure comparable to that required under the securities laws. Historically, these exemptions were premised upon the following assumptions:

-- that interests in these vehicles were offered not to the public, but to employers that are sophisticated investors and that can fend for themselves by obtaining adequate information and by negotiating with the vehicles' sponsors; and

-- that retirement plans were predominantly defined benefit plans, under which the employer made the investment decisions and bore the financial risk of ensuring the fund had sufficient assets to meet pension obligations.

When the exemptions were enacted, those assumptions were essentially correct, but in the past twenty years retirement plans have changed materially. A substantial and fast-growing portion of retirement plans now consists of defined contribution plans. Under these plans, the employee

often makes an investment decision about the vehicle in which the contributions allocated to the employee's account will be invested, and the employee bears the investment **risk** of the performance of the plan vehicles.

From a functional regulation perspective, it can be argued that mutual funds, bank collective funds, and insurance separate accounts sold to plan participants should be regulated under a common and uniform set of principles, and hence that bank collective funds and separate accounts should be regulated as management investment companies. Nevertheless, the costs of a major regulatory overhaul that would apply the Investment Company Act to these vehicles do not appear justified at this time. The Employee Retirement Income Security Act of 1974 imposes a number of obligations on those vehicles and generally provides investor protection in the same areas as the Investment Company Act, and we are unaware of any widespread abuses under the existing system that would be eliminated by applying the Act to these vehicles. Accordingly, the Division does not recommend that bank collective trust funds or insurance company separate accounts containing retirement plan assets be required to register under the Investment Company Act.

By contrast, these vehicles are not required to make significant disclosure to plan participants, yet participants who direct their own investments in defined contribution plans are in essentially the same position as any investor. For many Americans these pooled retirement vehicles are the most important investment in their lives. Those plan participants' investment decisions should have the benefits of the same disclosure obligations under the securities laws as other investment decisions. Accordingly, to ensure that plan participants receive full and fair disclosure, the Division recommends that:

> **The Commission should propose amending the Securities Act of 1933 to remove the exemption from registration for interests in pooled funding vehicles for participant-directed defined contribution plans. The Commission also should propose amending the federal securities laws to require the delivery of prospectuses to plan participants who direct their investments.**
>
> **The Commission should further propose amending the Securities Exchange Act of 1934 to require the delivery of semiannual and annual shareholder reports for the underlying investment vehicles (other than registered investment companies) to these plan participants.**

> The Commission should amend the rules under the Investment Company Act to require the delivery of semiannual and annual reports of underlying registered investment companies to these plan participants.

Such disclosure should help plan participants make more informed decisions about their retirement assets and promote greater competition among investment vehicles offered under defined contribution plans.

Removing Barriers to Cross-Border Sales of Investment Management Services

Internationalization and Investment Companies. As a result of technological advances and the removal of many legal impediments to foreign participation, the world securities markets have become internationalized to an unprecedented degree in the last decade. Although investors worldwide appear more eager than ever to diversify their investments with managed portfolios of foreign securities, access by United States investors to foreign investment companies and by foreign investors to United States investment companies generally remains limited, in large part because of legal barriers to cross-border sales of investment company shares. In view of the opportunities for both United States investors and investment companies if hurdles to cross-border sales are lowered, the Division recommends that the Commission adopt a multifaceted approach to remove such barriers.

Section 7(d) of the Investment Company Act is a major hurdle. This section prevents a foreign investment company from making a public offering in the United States unless the Commission finds that it can enforce the company's compliance with all provisions of the Act. The enforceability standard in effect prohibits foreign investment companies from publicly offering their securities in the United States since it requires them virtually to transform themselves into United States investment companies. Because of these burdens, no foreign investment companies have registered since **1973.** Accordingly, the Division recommends that:

> The Commission should propose amending section 7(d) of the Investment Company Act to permit foreign investment companies to sell shares in the United States if they can demonstrate that they are subject to regulation in their home country that provides substantially equivalent investor protection and that permitting their entrance into the United States markets would be in the public interest. To facilitate this process, the Commission should be authorized to enter into bilateral regulatory memoranda of

understanding with the securities authorities in countries with regulatory regimes providing the same type and quality of investor protections as provided by the Investment Company Act.

The Commission generally should support tax law changes to enable United States investment companies securing access to foreign markets to compete effectively with foreign investment companies, and the Commission should continue to work with state regulators to eliminate duplicative substantive regulation of investment companies.

Implementing these recommendations should create a framework for regulatory cooperation and mutual recognition of investment company regulation, thus providing complementary access to investment company markets without sacrificing investor protection.

The Reach of the Investment Advisers Act of 1940. The scope of the Investment Advisers Act is critically important for the internationalization of investment management services. When an investment adviser, foreign or domestic, registers under the Advisers Act, the Division has taken the position that all of the adviser's advisory activities everywhere are subject to the Advisers Act. Many of the Advisers Act's requirements, however, are different from or exceed those that apply to foreign advisers in their home country and may be contrary to accepted business practices there. Consequently, a foreign adviser that registers under the Advisers Act because it does business in the United States, as well as in its home country, may find itself unable to engage in legal and acceptable business conduct in its home country because the Advisers Act prohibits it. To avoid the consequences of this position, some foreign advisers establish "independent" subsidiaries, registered in the United States, to advise their clients here. Those subsidiaries, however, are subject to strict requirements that may restrict their ability to function effectively and also may reduce the quality of investment advice they are able to provide to United States investors.

To alleviate these problems, the Division recommends that:

The Division should issue no-action letters narrowing the application of the Advisers Act to the activities of registered advisers with their foreign clients, in accordance with a "conduct" and "effects" approach. Under that approach, the Commission generally would not regulate a registered foreign adviser's dealings with clients outside the United States, but would regulate a registered domestic adviser's dealings with foreign

> clients where a sizable amount of advisory conduct occurs in the United States. To ensure the Commission's ability to police overseas conduct that affects United States clients, registered advisers would still be required to maintain records regarding their own overseas trading and that of their clients and provide the Commission with access to their overseas personnel.

This approach would be consistent with the Commission's other international initiatives under the other federal securities laws. The approach also would permit greater flexibility for foreign advisory businesses to form and register separate subsidiaries or affiliates here.

<u>Performance Based Advisory Compensation</u>. The Advisers Act generally prohibits a registered investment adviser from receiving compensation on the basis of a share of capital gains in, or capital appreciation of, a client's account. Subject to specific requirements, limited exemptions from that prohibition are available for advisory contracts with registered investment companies, business development companies, and certain clients with significant assets. By contrast, many foreign countries do not impose any restrictions on performance-based fees, and such fees are a customary way of doing business in those countries. United States registered advisers, however, are subject to the Advisers Act's limits on such fees, even when dealing with non-United States clients. Moreover, none of the current exemptions is sufficiently flexible to permit sophisticated clients not needing the protections of the prohibition to structure advisory fees on terms they determine are appropriate.

To provide more flexibility in the use of performance fees, the Division recommends that:

> The Commission should propose amending the Advisers Act's limits on performance-based advisory fees to grant the Commission rule-making authority to exempt two types of advisory relationships from the restrictions on performance fees. First, United States registered advisers should be permitted to enter into performance fee contracts with non-United States clients to the extent that these compensation arrangements are lawful in the clients' home jurisdiction. Second, the performance fee restrictions should be amended to provide an exception for contracts with clients who the Commission determines by regulation, do not need the protections of the prohibition, based on factors such as wealth and financial sophistication.

The first change would reduce the competitive burden on domestic advisers seeking to compete in overseas markets. The second change would give United States registered advisers and sophisticated institutional investors greater flexibility to structure appropriate compensation arrangements.

Regulation of Investment Companies

Investment Companv Governance. The Investment Company AcYs requirements concerning the organizational structure of open-end investment companies, which interpose independent directors as a check on investment company sponsors, are fundamentally sound. They provide significant protections against the inherent conflicts between the interests of public investors and the interests of fund sponsors. At present, the Investment Company Act requires that a majority of the board be independent only in limited circumstances. To strengthen the independence of boards, the Division recommends that:

> The Commission should propose amending the Investment Company Act to require that the minimum proportion of independent directors on investment company boards be increased from forty percent to a majority, and that independent director vacancies be filled by the remaining independent directors. Independent directors should be given the authority to terminate advisory contracts.

At the same time, a small number of provisions would be amended to eliminate requirements that independent directors make detailed, formalistic findings in areas that generally do not present the potential for conflict between the interests of a fund and its adviser. Specifically, the Division recommends that:

> The Commission should amend rules under the Investment Company Act to streamline requirements for board review and approval of foreign custody arrangements, domestic securities depositories, and the time of day for determining net asset value.

These changes should increase directors' effectiveness by allowing them to focus on what they do best -- exercising business judgment in their review of interested party transactions and in their oversight of operational matters where the interests of a fund and its adviser may diverge.

While shareholder voting continues to be important as an effective means of communication, deterrence, and holding the board accountable, some

of the voting requirements under the Investment Company Act do not comport with the realities of modern securities markets and do not really protect investors. Accordingly, the Division recommends that:

> The Commission should propose amending the Investment Company Act to eliminate requirements that shareholders ratify the initial advisory contract, concur in the board's selection of fund auditors, or approve changes in relatively routine investment policies.
>
> The Commission also should recommend amending the Investment Company Act to require that shareholders approve any change in a fund's investment objective in order to clarify that the investment objective is a critical determinant of the potential risk and reward inherent in the shareholder's investment.
>
> The Commission should eliminate the requirement that shareholders ratify the initial rule 12b-1 plan (if any) of a newly organized fund, but should not recommend changes to voting requirements relating to amendments to rule 12b-1 plans that materially increase the amount spent on distribution.

The Investment Company Act relies on boards of directors to monitor investment company operations and resolve conflicts of interest; available data suggest that board operations impose minimal costs upon investment companies. Accordingly, the Division does not recommend changes that would permit the introduction of a unitary investment fund or other contractual structure that would eliminate shareholder and director voting. In view of the importance of director and shareholder voting requirements under the Investment Company Act, it would be fundamentally incompatible with the Act's regulatory philosophy to introduce such alternative structures, which would have little or no apparent benefits for investors.

The Sale of Open-End Investment Companv Shares. Over the past fifty years, tremendous changes have taken place in how mutual funds sell their securities (known as "distribution")and in how the sales are regulated. Today, the major distribution issue facing the Commission continues to be the degree and effect of competition in the mutual fund industry. We conclude that fund pricing is not as market-driven as it could be. Accordingly, the Division's recommendations focus on eliminating regulatory impediments to vigorous price competition, increasing investor understanding of total investment costs, promoting cost comparability among funds, and easing restrictions so that funds may experiment with distribution arrangements that make costs more explicit. We believe these

changes would promote price competition and more economical and efficient distribution methods.

a. Retail Price Maintenance. Section 22(d) of the Investment Company **Act** requires that investment company sponsors fix the prices at which redeemable shares are sold to the public and that retail dealers adhere to those prices. Together with section 22(f), which permits mutual funds to impose restrictions on transferability of shares, this provision inhibits price competition in the distribution of mutual fund shares, harming investors by causing higher prices than might otherwise be available in a competitive marketplace. Accordingly, in order to promote greater competition in the distribution of mutual funds, the Division recommends that:

> The Commission should propose amending section **22(d)** of the Investment Company Act to repeal the retail price maintenance requirement and to provide the Commission with explicit authority to issue orders or rules **to** deal with any issues of investor protection or the operation of the secondary market that may arise.

This proposal would promote retail competition among dealers and permit the market to develop more efficientmethods of mutual fund distribution. In addition, this proposal could facilitate the creation of new and innovative products that depend on free secondary markets in their securities.

b. Investor Choice. Since 1980, Commission rules and exemptive orders have permitted the development of a variety of distribution financing methods in addition to the traditional front-end loads. These innovations have included asset-based sales charges, contingent deferred sales loads, and the offering of multiple classes in the same portfolio. In response to a number of issues arising out of the use of these methods, the Division recommends that a variety of distribution options currently permitted under individual exemptive orders also be -codified and that certain outstanding rule proposals be adopted with appropriate modifications.

> The Commission should adopt its outstanding rule proposal to permit deferred loads, including installment loads assessed directly on a shareholder's account. While tax consequences apparently would inhibit widespread use of installment loads, there is no reason to require individual exemptive orders for their use.

> The Commission should adopt only limited amendments to the rule governing asset-based sales loads, or rule 12b-1 fees, consistent with the continued use of spread loads and the proposal by the National Association of Securities Dealers, Inc. to regulate these loads under its maximum sales load rule.

> The Commission should adopt a new exemptive rule to permit multiple class arrangements which can increase investor choice, result in economies of scale and certain efficiencies in the distribution of fund shares, and allow fund sponsors to tailor products more closely to the needs of investors.

In combination, these changes will allow funds to offer investors a variety of methods of financing distribution costs while enhancing investors' comprehension of their choices.

c. Unified Fee Investment Companies. The array of fees and loads available to investors does increase investor choice but also may impede price competition. The Division believes that price competition might be improved if, ironically, still *another* form of investment company were permitted -- one with a simplified fee structure and low barriers to exit by dissatisfied shareholders. Accordingly, the Division recommends that:

> The Commission should propose amending the Investment Company Act to permit the introduction of a new investment vehicle -- a unified fee investment company ("UFIC"). The UFIC would have a single, fixed fee, set by the vehicle's "investment manager" and no sales charges or redemption fees. All UFIC expenses, except brokerage commissions on the fund's own portfolio transactions and extraordinary costs, would be paid from the fee or from the manager's own resources. Rule 12b-1 would not apply. The level of the fee would be prominently displayed on the cover page of the prospectus and in all sales literature and advertising. To protect investors should competition not restrain fee levels for the UFIC, the Act would prohibit "unconscionable or grossly excessive" unified fees. The fee would not require shareholder or director approval nor would it be subject to private litigation.

Because such funds would not impose either front-end or deferred sales loads, dissatisfied investors could "vote with their feet." A unified fee structure would substitute market competition for the oversight role of boards of directors and courts, who today review the fee levels of investment companies to prevent excessive charges to investors. The UFIC would have a board of directors to police operational conflicts and approve a variety of activities, just as do other funds. The board would oversee the

level of services provided to the UFIC through review of all material contracts.

Investment Company Advertising. Under the Securities Act, investment companies historically have experienced unique problems communicating with the public. First, unlike traditional issuers which generally only offer their shares periodically, mutual funds and unit investment trusts continuously offer and sell their shares and units to the public, and, therefore, are continuously subject to the Securities Act's advertising requirements. In addition, because the Securities Act broadly defines the term "offer," and because the "products" of an investment company are its securities, virtually every written attempt by an investment company to promote and make the public aware **of** its products is potentially an offer to sell **its** securities that must conform to the Securities Act's advertising requirements. Traditional issuers, in contrast, whose products are not securities, do not have this problem and may advertise their products more freely. Finally, the advertising restrictions of the Securities Act restrict direct-marketed funds more than funds sold through brokers. Direct-marketed funds use print, radio, and television almost exclusively to sell fund shares, while broker-sold funds employ sales personnel who sell fund shares orally. Since the advertising restrictions of the Securities Act generally apply to written communications but not to oral communications, broker-sold funds have an advantage over direct-marketed funds. To promote more effective written communications with investors, the Division recommends that:

> The Commission should propose amending the Securities Act to delete the requirement that all of the information in an investment company's "omitting prospectus" must be derived from the statutory prospectus and to add a provision for a new "advertising prospectus" for investment companies. The contents of the advertising prospectus would not be restricted to information "the substance of which" is contained in the statutory prospectus. In addition, the Commission should rescind the special provisions in the tombstone rule for investment companies.
>
> The Commission should also adopt amendments to the Securities Act rules to permit mutual funds to sell "off-the-page" directly from advertisements, as is the practice in several European countries, without requiring that investors first receive a statutory prospectus. Off-the-page advertisements would be required **to** contain such information as the Commission may prescribe, such as fees and expenses, performance data, investment objectives,

and risks. The advertisements would also be required to inform investors about the availability of a statutory prospectus, and the mutual fund would still be required to deliver a statutory prospectus to investors prior to, or with, the earlier of the confirmation of the sale or the delivery of the security. In addition, off-the-page advertisements would be section 10 prospectuses, and hence subject to section 12(2) prospectus liability.

These proposals should make it easier for investment companies to market their funds and for investors to receive useful information. In addition, the proposals would subject all investment company advertising to prospectus liability which, in turn, will maintain the high level of investor protection that exists today.

Variable Insurance. Variable annuities and variable life insurance contracts are regulated both as insurance products under state law, and as securities under the periodic payment plan model under sections 26 and 27 of the Investment Company Act, which imposes considerable limits on individual charges such as distribution costs and administrative fees. With variable insurance products, the policyholder's premium payments are allocated to a segregated or "separate" account investing in a portfolio of securities, not to the company's general account (which receives premiums for most life insurance and annuity policies). Under variable contracts, certain benefits (such as cash surrender values, annuity payments, and death benefits) reflect the investment performance of the portfolio of the applicable separate account. While variable insurance contracts are regulated as periodic payment plan certificates, they are not comparable investment products. The variable life contracts, in particular, have huge start-up and issuance costs, and multiple insurance and administrative costs that are not provided for adequately under current Investment Company Act regulation. In addition, because the contracts are hybrids of insurance and investment, with state insurance law applying to the insurance elements of the contracts and federal securities laws to the investment elements, difficult jurisdictional and practical problems arise, particularly over the regulation of contract charges. Accordingly, in order to recognize the unique nature of variable insurance contracts the Division recommends the following:

The Commission should recommend amending sections 26 and 27 of the Investment Company Act to exempt variable insurance contracts from certain charge limitations under those provisions and to improve flexibility of pricing by requiring aggregate contract charges simply to be reasonable in relation to the services rendered under the contracts, the expenses expected to be incurred, and the risks assumed by the insurance company. The

amendment also should provide the Commission with rulemaking authority to establish standards of reasonableness if the market should fail to provide competitive prices or if abusive industry practices should develop.

Under the amendment, the Commission's role in regulating contract charges would be made more consistent with the unique features of variable insurance and the Commission's approach to regulating charges in the mutual fund industry.

Repurchases and Redemptions of Investment Company Shares. Traditionally, investment company regulation has maintained a relatively rigid separation between open-end and closed-end investment companies. Open-end companies must price their shares daily and pay redemption proceeds to investors within seven days of receipt of a redemption request. With limited exceptions, closed-end companies may not repurchase their shares directly from shareholders, except through cumbersome and expensive tender offers. Some investment companies today elect closed-end status because they invest in markets that, for various reasons, make it impractical to pay redemption proceeds within seven days. Many closed-end companies, however, tend to trade at a discount from their net asset value and thus are unattractive to many investors. Accordingly, to permit a greater range of options and innovation, the Division recommends that:

> The Commission should adopt a new rule under section 23 of the Investment Company Act defining circumstances under which closed-end companies may conduct regular repurchases of their shares directly from shareholders at prices based on net asset value.
>
> The Commission also should adopt a new exemptive rule under section 22 of the Investment Company Act permitting new variations on the open-end form, to be called "limited redemption" investment companies, offering alternative redemption and offering procedures to investors. Such companies would be either ***extended payment companies,*** which would redeem shares continuously but take longer to make payments than the seven days currently mandated for open-end companies, or ***interval companies,*** whose shareholders could redeem at fixed regular intervals, such as monthly. To prevent investor confusion, the new rule should require prominent, clear disclosure of a fund's limits on redeemability and prohibit the use of the term "mutual fund" and similar expressions in connection with these

> new companies. In other respects, the new kinds of funds should be regulated in the same manner as traditional open-end investment companies.

These new procedures would give shareholders the ability to invest in managed portfolios with less liquidity than mutual funds, while retaining the ability to exit the fund at a price based on net asset value.

Finally, because of the importance of portfolio liquidity to an investment company's ability to redeem or repurchase its shares, the Division recommends that:

> The Commission should propose amending the Investment Company Act to make express a portfolio liquidity requirement for all companies that redeem or regularly repurchase their shares and to give the Commission authority to prescribe appropriate liquidity standards.

Liquidity requirements would help protect investors' reasonable expectations regarding their ability to exit a particular fund at net asset value.

Affiliated Transactions. The Investment Company Act has as one of its cornerstones strict prohibitions on transactions involving investment companies and their affiliates. These prohibitions go beyond those imposed by common law, by federal and state law on other types of pooled investment vehicles, such as bank common trust funds and commodities pools, or by foreign laws regarding investment companies. Because there is significant potential for abuse in many affiliated transactions, it would be unwise to make sweeping changes to the provisions of the Act concerning transactions involving investment companies and their affiliates, such as authorizing fund boards of directors to approve all such transactions. At the same time, however, some limited relief is appropriate to permit limited classes of transactions with affiliates that do not present significant conflicts, subject to review by boards of directors. Accordingly, the Division recommends that:

> The Commission should amend the limitations on joint transactions under rule 17d-1 to broaden the class of transactions currently permitted by allowing directors of investment companies to authorize joint transactions with remote affiliates, and by exempting joint transactions where an investment company and its affiliates participate on the same terms, except to the extent of their participation.

The Commission should adopt amendments to rule 10f-3, which allows limited purchases by investment companies from underwriting syndicates that contain affiliates, to permit purchases in overseas markets.

Procedures for Exemptive Orders. The authority to issue orders granting exemptions from the Act is vital to the Commission's ability to administer the Act flexibly and promptly in response to new developments in the financial markets. The large number of applications reviewed by the staff illustrates the extent to which the Commission and the industry depend on the process. In order to strengthen the ability of the staff and the Commission to respond promptly, the Division recommends that:

The Commission should adopt a rule providing for expedited treatment of routine applications for which there is recent, fully applicable precedent. Applicants employing this procedure generally would receive relief no later than 120 days after filing an application.

The Commission should expand the delegation of authority to the Division Director under existing regulations to expedite review of applications.

The Division believes that more radical revisions to the existing exemptive authority would be both unwise and unnecessary.