Comments of

the Investment Company Institute

on the Reform of Regulation of Investment Companies

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I. INTRODUCTION AND SUMMARY

The Investment Company Institute[1] applauds the Commission for undertaking this important and timely re-examination of the Investment Company Act of 1940 (the "Act" or the "1940 Act"). Indeed, publication of the Commission Release[2] coincided with the final stages of a two year study undertaken by the Institute of possible changes to the Act, and the recommendations set forth herein represent the culmination of this industry study. Numerous individuals from all segments of the industry have participated in the study and in the development of these recommendations, which reflect a broad industry consensus.

In this fiftieth anniversary year, it is appropriate that the industry and the Commission reassess the 1940 Act, which was jointly drafted by representatives of government and industry to address problem areas and to provide a regulatory framework for the future.[3] Since enactment of the 1940 Act, the investment company industry has grown from assets of approximately $2.1 billion[4] to over $1.2 trillion. Today, one out of four American households and hundreds of

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1 The Investment Company Institute is the national association of the American investment company industry. Its membership includes 3,074 open-end investment companies ("mutual funds"), 203 closed-end investment companies and 13 sponsors of unit investment trusts. Its open-end and closed-end investment company members have assets of about $1,064 billion, accounting for approximately 90% of total industry assets, and have over 30 million shareholders.

2 Release No. 33-6868, 34-28124, IC-17534, IA-1234, International Series No. 128 (hereinafter the "Release").

3 Bullock, The Story of Investment Companies (Columbia University Press, 1959) at pp. 74-78.

4 Report of the Securities and Exchange Commission on the Public Policy Implications of Investment Company Growth, 1966 at p. 2.

thousands of institutional investors own shares of investment companies. From almost every perspective, it must be agreed the 1940 Act has served both investors and the industry well.

Indeed, the industry believes that the core objectives of the Act are as relevant today as they were in 1940 and should be reflected in any revised statute. For example, the statute should continue to: 1) insure that investors receive adequate, accurate information about the investment company; 2) protect the physical integrity of the company's assets; 3) prohibit or regulate forms of self-dealing; 4) restrict unfair and unsound capital structures; and 5) insure fair valuation of investor purchases and redemptions.

While the 1940 Act continues to work well in the interests of both investors and industry, it is also apparent that modifications would benefit all parties. This results from the fact that the drafters of the Act based their work on "snapshots" of the financial world as it existed in 1940. Not surprisingly, the past fifty years have seen substantial changes in that world.

For example:

* In 1940, closed-end funds, mutual funds, unit trusts and face amount certificates were practically the only types of pooled investment media offered to the public. Quite naturally, the Act focused on these particular types of funds. However, over the intervening decades, numerous new types of publicly-offered pooled securities funds, which raise precisely the same public policy concerns, have

come into existence. Yet many of these new types of funds have not been required to register under the Act.

* In 1940, investment companies were mainly sold to individuals. The Act imposed a detailed set of substantive requirements on investment companies in order to protect these small investors.[5] Today many investment companies are specifically designed for large institutional investors. Yet these institutional funds are subject to every provision of an act designed to protect small investors.

* In 1940, closed-end funds were the predominant type of managed investment company.[6] The drafters of the Act required all managed funds to utilize structures and systems designed for closed-end funds (e.g., the 1933 Act distribution system and a corporate form of governance). Today mutual funds are by far the most popular type of managed investment company,[7] but are required to operate under rules designed for closed-end funds.

* In 1940, US funds had little interest in selling overseas and foreign funds had little interest in selling in this country. Both the 1940 Act and foreign laws

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[5] In his statement when he signed the Act, President Roosevelt expressed the hope “that the act which I have signed today will enable the investment trust industry to fulfill its basic purpose as a vehicle to diversify the small investor’s risk. . . .” The Wall Street Journal, August 24, 1940.

[6] In 1936, when the SEC began its study of the industry, closed-end funds had total net assets of just over $1 billion, while mutual funds had assets of $356 million. Investment Company Institute, Management Investment Companies (Prentice-Hall, 1962) at p. 96.

[7] As of September 30, 1990, mutual funds had total net assets of over $1 trillion, while closed-end fund assets amounted to approximately $60 billion.

created barriers to cross-border offerings. But today US and foreign fund sponsors have a growing interest in overseas sales.

These and other changes which have occurred over the last half century indicate the need to revise the 1940 Act to meet modern conditions, while maintaining the Act's core objectives.

The body of this letter sets forth the revisions which we believe should be made. Our major recommendations are as follows:

1. All publicly-offered pools of securities (including bank common and collective funds, asset-backed arrangements and mortgage REITS) should be made subject to the Act, with the Commission vested with authority to promulgate appropriate rules and exemptions for particular types of pools, just as the SEC has adopted special rules for variable insurance products.[8]

2. Managed investment companies should be permitted the option of organizing either in traditional corporate form or in unitary (contract) form, the predominant structure used in other countries.

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[8] In contrast to this suggested reform, the Release starts with the assumption that traditional investment companies should be regulated more and more, while the coverage of other securities pools is considered controversial. In recent years, this approach has imposed an increasingly heavy burden of regulation on traditional investment companies covered by the Act, while competing pools have little or no regulation. Indeed, it is ironic that the substantial burden of detailed regulation applicable to traditional investment companies may actually have increased the Commission's reluctance to have new securities pools covered by the Act. See, for example, the discussion of the coverage of asset-backed arrangements on pp. 32-39 of the Release, where the Commission questions whether regulation under the 1940 Act is appropriate.

3. Unit trusts investing in fixed portfolios of securities should be permitted to be organized either in open-end form (as under present law), or in closed-end form. The use of the closed-end form would permit the public offering of certain mortgage-backed and asset-backed arrangements which presently cannot be publicly-offered since they cannot comply with the Act.

4. The Act should be amended to remove the current rigid open-end/closed-end dichotomy so as to permit funds to redeem on a periodic basis. This would allow the creation of innovative products and could serve to reduce closed-end fund discounts.

5. Funds which are limited to institutional investors should be exempted from various provisions of the Act, including those relating to governance, capital structure and redeemability. After experience has been gained in this area, the Commission should report to Congress on the advisability of extending some or all of these changes to other funds.

6. Mutual funds should be permitted to make written offers without prospectus liability, just as broker-dealers are permitted to make oral offers without such liability. The requirement to deliver a prospectus at the time of sale should be retained.

7. Advertisements which are subject to prospectus liability should be permitted to include purchase applications, so that investors may purchase shares directly on the basis of those advertisements.

8. The United States should negotiate treaties with other nations providing for cross-border sales of investment company shares provided there is both adequate investor protection and equal market access.

In 1941, Alfred Jaretzki, who participated in the drafting of the Act on behalf of the closed-end industry, wrote:

> "In the light of experience some amendments will undoubtedly be necessary. But in general it is the belief of the writer that the Act in its present form, because of the specific prohibitions, because of its prophylactic effect, because of the intangible influence which the Commission is able to exercise, and because of the continuing cooperation between the Commission and the industry, will prove to be a satisfactory piece of legislation."[9]

We are extremely pleased that the Act has proven to be more than "satisfactory", from the perspective of investors, the Commission and industry. However, after half a century, it is not surprising there is a need to update the Act to meet modern conditions, while maintaining the Act's core objectives. In this regard, we hope that the Commission will give serious consideration to the suggested revisions to the Act contained herein. Equally important, we hope

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[9] Jaretzki, "The Investment Company Act of 1940", 26 Wash U. L. Q. 303 (1941).

that the Commission and the industry will continue their half century of cooperation, both in the process of re-examining the Act and in working together under a revised and updated statute.

II. COVERAGE OF THE INVESTMENT COMPANY ACT

The first issue that must be addressed in the consideration of modernization of investment company regulation is the scope of the regulation. In other words, which entities should be deemed "investment companies"?

In this regard, the Institute urges the Commission not to confine its review simply to those entities that currently fall within the statutory definition. Simply doing so would continue the detailed, substantive regulation of traditional investment companies, while similar pooled products, which raise the very same public policy issues, will be able to operate outside the statutory framework. This would perpetuate the current and growing competitive disadvantage under which traditional investment companies operate. More importantly, investors in those non-regulated pools will continue to be denied necessary protections.

The recent significant changes in the securities markets that warrant re-examination of the Investment Company Act are quite relevant to a reconsideration of the proper scope of the Act. Several of the exemptions that may have been warranted in 1940 (or even in 1970) may no longer be sound, as the result of changes in the manner in which such products are operated and sold. In addition, new types of products have developed since the Act was signed into law. It is, therefore, necessary to start with a clean slate in determining "What is an investment company?"

A. Publicly-Offered Pools of Securities

In order to determine which entities should be regulated as "investment companies", reference must be made to the core policy goals of the statute, specifically, what potential abuses exist that require investor protection. As discussed above, the core policy concerns of the Investment Company Act include: the need for investors to receive adequate information about the nature of the investment company, the need to protect the physical integrity of the company's assets, the need to guard against self-dealing, the need to restrict unfair and unsound capital structures and the need to assure fair and accurate valuation.

Many of these concerns arise in the case of any "packaged" investment vehicle, i.e., any security that represents an interest in other assets, including, for instance, pools of equity interests in real estate, collectibles, coins, foreign exchange, etc. Although not without merit, the Institute believes that extending the scope of the Investment Company Act to all pooled investments is not practical and would make the statute difficult, if not impossible, to administer. Therefore, the Institute recommends that the scope of the Investment Company Act be limited to pools of securities.[10]

In addition to the practical considerations favoring this approach, there are certain unique features of securities pools that warrant their regulation under a separate regulatory scheme.

[10] In this regard, the definitions in Section 3(a) of the Investment Company Act, particularly Sections 3(a)(1) and 3(a)(3), are appropriate as they cover both issuers that hold themselves out as investment companies and de facto investment companies.

First, securities are generally more liquid and fungible than other assets. As a result, some of the concerns with respect to any investments (e.g., the integrity of the underlying assets) are more likely to arise in the case of securities pools. In addition, it may be harder to detect and prevent certain forms of self-dealing in the case of securities pools.

Second, other types of pooled investments may involve a greater degree of operational management than in the case of most securities pools. For example, certain real estate and oil and gas pools may involve maintenance and operational management on the part of the sponsors. As a result, it would be difficult to regulate such entities under a revised Investment Company Act.

While the Institute believes generally that all publicly-offered securities pools should be regulated under the 1940 Act, there may be entities that should nonetheless be exempted from the Act to the extent that they do not raise the investor protection concerns addressed by the Act. Many of these entities currently are exempted from the definition of "investment company" under the Act, and the Institute believes that these exemptions are justified. Examples include issuers primarily engaged in non-investment businesses, private investment companies, underwriters and broker-dealers and bona fide banks and insurance companies.

In general, however, we believe such exemptions should be construed narrowly so as not to frustrate the purposes of the Act. Most importantly, as recommended in the 1984 report of Vice President's Task Force on Regulation of Financial Services, Blueprint for Reform, the concept of functional regulation should be a guiding principle. Specifically, all securities pools

should be subject to similar regulation regardless of the type of entity serving as sponsor, adviser or underwriter to the pool. In this regard the fact that the manager of the pool (or the pool itself) might be subject to a different regulatory scheme does not provide sufficient grounds for exemption from the Investment Company Act.

B. Specific Examples

The drafters of the 1940 Act considered the various types of securities pools that existed in 1940 and determined which types of pools were in need of regulation and which should be exempted. However, many exemptions that may have been narrow and reasonable at the time of enactment have become questionable due to changes in the manner in which various types of pools are operated and sold.

This has two consequences. First, the Commission must continually decide, on a case-by-case basis, whether specific offerings (such as certain asset-backed arrangements and, if a recent OCC proposal is adopted, bank common trust funds) fit within the statutory exemptions. Second, to the extent that such offerings are exempted, there is the danger of regulatory inconsistency, under which registered investment companies are subject to a comprehensive regulatory scheme, while similar products are not. The Institute is concerned that certain of the exemptions contained in the 1940 Act have been "stretched" beyond their original meaning. The result is that investor protection is undermined and traditional investment companies alone are burdened with extensive regulation. Examples of the types of securities pools that should be

regulated as investment companies are bank common and collective funds, asset-backed arrangements and mortgage REITS.

1. Bank Common and Collective Funds

Federal banking regulations first permitted national banks to commingle assets of bona fide personal trusts already managed by the banks (thereby creating common trust funds) in 1937. Strict prohibitions were imposed on the mass merchandising of these funds. Based on these restrictions, Congress exempted such funds from regulation under the federal securities laws, including the 1940 Act.

In 1955, banking regulations were amended to permit a second type of pooled fund -- collective investment funds for the commingling of assets of retirement plans already managed by the banks. These funds, subject to similar restrictions on advertising and merchandising, were exempted from regulation under the federal securities laws in 1970. However, in 1972, two years after Congress enacted the exemptions, the Comptroller of the Currency reversed the prohibition against the public offering of these collective funds. Today banks mass-market interests in these funds to retirement plans and to thousands of individual employees in those plans. The Comptroller now has proposed removing the advertising and marketing restrictions on common trust funds.[11]

[11] Fiduciary Powers of National Banks and Collective Investment Funds, 55 Fed. Reg. 4184 (1990).

Unless regulated as investment companies, bank common trust funds will be, as bank collective funds currently are, offered to the public, yet exempt from the investor protections of the 1940 Act. For example, OCC regulations governing common and collective funds do not establish advertising standards,[12] do not require prospectus delivery and disclosure, and do not prohibit self-dealing transactions that are forbidden under the 1940 Act.[13]

The Commission has stated that if the Comptroller's common trust fund proposal is adopted and banks advertise common trust funds or place assets not held for bona fide fiduciary purposes in these funds, the funds would be required to register under the Act.[14] While the Institute supports the Commission's position, it believes more must be done to close existing gaps in investor protection. Bank collective funds for retirement plans continue to function as investment companies, but are free from 1940 Act regulation as such. Moreover, there will

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[12] In 1978, Senator Proxmire, the Chairman of the Senate Banking Committee, said of advertisements for bank collective funds, "It's astonishing that they can do this and the SEC has no authority, no jurisdiction and they can do that in competition with [the mutual fund] industry". Hearings on S. 72 before the Senate Committee on Banking, Housing and Urban Affairs, 95th Congress, 2nd Session (1978) at 348.

[13] For example, bank common and collective funds can (and do) invest in CDs of the sponsoring bank. The 1975 annual report for the Citibank collective fund for Keogh plans disclosed that 40 percent of the fund's assets were invested in a Citibank certificate of deposit. As of year-end 1988, trusts administered by banks had invested almost $17 billion in deposit instruments of the affiliated bank. "Trust Assets of Financial Institutions - 1988," Federal Financial Institutions Examinations Council (1988).

[14] See letter to Robert L. Clarke, Comptroller of the Currency, from Richard C. Breeden, Chairman, Securities and Exchange Commission, dated July 9, 1990. The Comptroller's proposal also would allow a separate management fee to be assessed against the assets of the common trust fund, in addition to fees charged to individual trust accounts. The Institute believes that, since the exemptions from the securities laws for common trust funds were based on the fact that these funds were administrative devices, which should reduce costs, the imposition of such a second fee on common trust funds undercuts the operative assumption and should require these funds to be registered under the Act.

remain continuing interpretive questions as to whether a particular common trust fund is exempt from the Act.

Whatever justification there might have been at one time for exempting certain bank-sponsored investments pools from the 1940 Act, it is difficult to see what purpose is served by these exemptions today. For the most part, the common and collective trust funds sponsored by banks today bear little resemblance to the traditional fiduciary activities offered by bank trust departments in the 1930s. Moreover, the fact that, to some extent, trust services are performed in addition to investment management does not justify removing the product as a whole from the regulatory structure for investment companies. These additional trust services could continue to be regulated by the appropriate state regulators or the OCC.

The Institute therefore agrees with former SEC Chairman Shad that bank common and collective funds should be made subject to the Act and the other federal securities laws.[15] Of course, to the extent that a fund might fall within another exemption (e.g., the private offering exemption), it would not be required to register. In addition, there may be features of some of these funds that would make exemptions from certain provisions of the Act appropriate, and therefore the Commission should have authority to promulgate appropriate exemptive rules and orders. For example, certain collective funds for retirement plans that are sold only to institutional investors should be entitled to relief from certain provisions of the Act, including

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[15] See Statement of John S. R. Shad, Chairman of the Securities and Exchange Commission, Before the Senate Committee on Banking, Housing, and Urban Affairs at 20 (June 8, 1983). See also General Accounting Office, Financial Regulation: An Analysis of Two Types of Pooled Investment Funds (May 1986) (discussing the application of functional regulation to mutual funds and bank collective investment funds).

corporate governance and daily redemptions. (The Institute's specific recommendations for institutional funds are discussed in greater detail in Part III. D. below).

The issue of bank common and collective funds is, of course, related to a broader one discussed in the Release--the possible full-fledged entry by banking organizations into the investment company business. The Institute has endorsed an affirmative legislative proposal to permit banks and securities firms reciprocal entry into each other's business[16] with amendments to the securities laws designed to ensure the same degree of investor protection for bank-affiliated funds as exists for investment companies sponsored, advised and underwritten by securities firms.

The Institute, therefore, supports the approach taken in 1988 by the Commission in its recommended amendments to the 1940 Act and Investment Advisers Act. Specifically, the Institute believes that investment company activities should be permitted only for a separate affiliate of a bank holding company (as opposed to the bank itself or a subsidiary of the bank) that is regulated by the Commission. In addition, in order to protect against investor confusion and abuses due to an affiliated bank's role as a commercial lender, a special set of investment company firewalls, similar to those currently in the Act dealing with investment companies and securities firms that sponsor and advise them, should be enacted. As noted in past Commission testimony, the 1940 Act and the Investment Advisers Act were drafted in the context of a strict separation between the banking and securities businesses, and there was, therefore, thought to be

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[16] See Statement of David Silver, President, Investment Company Institute, before the Committee on Banking, Housing and Urban Affairs, United States Senate, on Legislation to Modernize the Regulation of Financial Services (April 24, 1990).

no need to include such provisions in the 1940 Act. The Institute's legislative proposal includes these firewalls, many of which were also recommended by the Commission in 1988. Among the specific protections recommended by the Institute are restrictions on the use of the name of an affiliated bank by a fund, restrictions on the investment by managed trust accounts in securities issued by an affiliated fund, restrictions on fund investments in securities issued by borrowers from an affiliated bank, and authority for the Commission to impose requirements on a bank serving as custodian of an affiliated fund.

2. Asset-Backed Arrangements

While banks have attempted to use the exemptions of Section 3(c)(3) and 3(c)(11) of the Act in order to mass-market investment company products to the public, there also have been attempts to expand upon the language and purpose of Section 3(c)(5) in order to exempt various asset-backed arrangements from the Act's coverage.

However, as Professor Tamar Frankel, a leading expert on the regulation of investment companies, has noted, current statutory exemptions generally do not encompass asset-backed arrangements, such as pools of credit card receivables[17]. Professor Frankel points out that the purpose of the exemption contained in Section 3(c)(5)(A) was to exempt factoring companies engaged in the commercial finance business. This is evidenced both by the legislative history of the Act and the plain language of the statute, which requires issuers to be primarily engaged "in the business" of making or investing in certain types of loans in order to qualify for the

[17] See letter to Kathryn B. McGrath, Director, Division of Investment Management, from Tamar Frankel, Professor of Law, Boston University (Jan. 26, 1990).

exemption. The factoring companies described in Section 3(c)(5)(A) have little or no relation to the passive pools, such as those consisting of consumer loans, being offered today.

Most importantly, Professor Frankel notes that the very same policy concerns that led to the adoption of the Act are present in the case of asset-backed arrangements. For example, in the typical case of a pool backed by credit card receivables, the grantor of the trust both retains a residual interest in the pool and services the loans, so as to have the right to substitute loans, alter their terms and undertake collection. There are clear potential conflicts of interest inherent in such an arrangement, and it was for these very reasons that the 1940 Act was enacted.

It is true that, to date, many offerings of asset-backed securities have included safeguards. For example, in a typical transaction, the securities offered are rated by a rating agency, the portfolio securities are held by an independent trustee and described in the prospectus, the portfolio securities must be "representative" of those in the grantor's own portfolio and the trust is permitted to invest in the grantor's own securities only if certain conditions are met.

However, these safeguards are not adequate substitutes for the protections of the 1940 Act. First, many of the conditions are not mandated by law but have been voluntary. Moreover, while most offerings to date have been made by sophisticated, responsible financial entities and underwritten by independent firms, there is no guarantee that this will continue in the future. Second, many of the requirements (e.g., that the portfolio securities be "representative") are so devoid of objective standards that they present a clear opportunity for abuse. (Indeed, given the nature of assets of certain depository institutions in recent years, it does not necessarily give

comfort that the securitized loans sold to the public are "representative" of those retained.) Third, many of the provisions (e.g., prospectus disclosure, independent custodian) are equally applicable to traditional investment companies, yet they have never been considered adequate replacements for core 1940 Act protections, such as the restrictions on self-dealing and capital structure.

If, however, the Commission disagrees and believes that the protections of the 1940 Act can be replaced by disclosure, delegation to private rating agencies, or some combination thereof, the Institute submits that such "flexibility" should not be limited to asset-backed arrangements. Instead, any investment company should be allowed to rely on these alternate means of satisfying the policy concerns of the Act.[18]

It also should be noted that at present many asset-backed arrangements cannot be offered to the public, since they cannot comply with certain provisions of the Act and cannot qualify for an existing exemption. We believe that many of these arrangements should qualify for public offerings and for this reason, we have made recommendations in Part III of this statement designed to permit various asset-backed arrangements to register under the Act and be offered to the public.

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[18] For example, there have been several (private) offerings of securities backed by high-yield bonds. There is no justification for treating pools backed by credit card receivables differently from pools backed by high-yield bonds. Indeed, if anything, there is a greater potential for abuse in the case of the former, due to the grantor's extensive role in servicing the loans.

For example, if, as we suggest in Part III.B, closed-end unit trusts were permitted, fixed portfolios of asset-backed arrangements could be publicly offered, with several classes of securities and a non-corporate structure. In addition, our proposed exemptions for institutional funds in Part III.D would permit managed portfolios, such as credit card pools, to employ a multiple class structure, to issue periodically redeemable shares and to seek special exemptive relief from the prohibitions of section 17. We believe that these revisions to the 1940 Act would allow the structured financing market to continue to develop and, indeed, expand the types of asset-backed pools that can be offered by allowing pools containing other types of securities to employ the structured financing approach. At the same time, in the case of managed pools offered to retail investors, the full protections of the 1940 Act would apply.

3. Mortgage REITS

As noted above, it may be difficult for the Investment Company Act to encompass pools of "hard assets", such as equity interests in real property. However, there is no reason why the Act should not apply to pools investing in mortgages, such as mortgage REITs.

Indeed, the function of a REIT is exactly the same as that of a mutual fund--to make available to investors a diversified investment portfolio under professional management. Moreover, REITs often have organizational structures that are similar to those of mutual funds. Typically, REITs are organized, managed and promoted by an external management organization. REITs seldom have more than a few employees of their own, relying instead on the officers and employees of their external advisers to manage their business.

Like advisers to mutual funds, REIT advisers have an incentive to increase the assets under their management through superior performance and the continuous sale of new securities, since an increase in assets results in increased profits for the adviser, who generally is paid a management fee based upon a percentage of assets. Thus, as assets under management grow, the adviser's fee increases.

However, there is one major distinction between mutual funds and REITs: whereas mutual funds and their advisers are subject to the stringent self-dealing prohibitions of the Investment Company Act, REITs and their advisers are not subject to such regulation.

As a result, the bank-REIT story of the early 1970s presented an eerie replay of the conflicts of interest of the 1920s which led to the enactment of the Investment Company Act. For example, a major bank motive in sponsoring a REIT was to "assure its customers a source of real estate funds"[19] for high risk or otherwise unsuitable loans for the bank. Thus, banks could use their affiliated REITs "to avoid the existing bank restrictions on land and development loans"[20] to their customers. The banks also sold loans from their own portfolios to their affiliated REITs when they needed to increase their liquidity or free up money for other purposes. Although such transactions may have served the banks' interests, they exposed REIT shareholders for serious financial risks, since the banks had substantial incentives to tailor the transactions for their benefit.

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[19] Schulkin, Real Estate Investment Trusts: A New Financial Intermediary, New England Economic Review, November/December 1970, at 6.

[20] Id.

The inability of any single regulator to police adequately transactions involving bank-sponsored REITs and affiliated banks had disastrous consequences for investors. On one side of the fence, the SEC, which only possessed disclosure jurisdiction under the 1933 Act, lacked the power to prevent the banks in question from exploiting such conflicts of interest. On the other, the bank regulators evidenced no real interest in protecting REIT investors. REIT investors suffered the consequences of this splintered regulatory authority when the conflict-laden bank-sponsored REITs soon encountered economic difficulties and their share prices plummeted.

The bank-REIT debacle of the early 1970s demonstrates that disclosure alone is not sufficient to adequately protect investors in pooled securities funds. What is needed is substantive regulation under the 1940 Act.

4. Insurance Products

The Release requested comment on the coverage of various insurance products, such as variable annuities and variable life insurance, under the 1940 Act. In general, the Institute believes the current treatment of these products is correct. As the Supreme Court has held, these products are securities that represent interests in pools of securities, since the investor is subject to the risks of investment.[21] Thus, they raise the same investor protection concerns as do traditional investment company products. The fact that the products are offered by insurance companies, or separate accounts established by insurance companies, does not provide a justification for a wholesale exemption from the 1940 Act. Under the principle of functional

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[21] SEC v. Variable Annuity Life Insurance Company, 359 U.S. 65 (1959).

regulation, securities pools should be regulated consistently, regardless of the type of institution sponsoring the pool. Moreover, as the Commission and the Supreme Court have recognized, state insurance regulation is addressed to wholly different policy concerns than the investor protection goals of the federal securities laws.

There is, however, a need for flexibility in regulation so that the unique features of insurance products may be accommodated. The Commission has followed this approach and has adopted several exemptive rules in this area for both variable life insurance and variable annuity contracts. The Institute believes this is the proper approach and that the Commission should, as necessary, grant further class exemptions (e.g., to exempt variable annuity contracts from certain provisions of Section 26 and Section 27 under the Act) so long as they are consistent with investor protection.

In addition, the approach taken by the Commission in the insurance area should be the model for regulation of other pooled securities products that may merit special accommodation under the 1940 Act.

C. Other Issues

The foregoing discussion has adopted as its starting point the concept of a "securities pool". While the question of what is a security has been extensively developed through case law, the question of what is a "pool" has received less attention. It is possible, however, that as new

technologies and investment strategies develop, the question will become central in determining the scope of the 1940 Act.

This question has arisen in the past in the case of individual, but identical, small accounts managed by the same investment adviser, also known as "mini-accounts". In addition, securities tied to indices have been issued that were in fact backed by securities representing promises to pay (such as in the case of "index participations") or that were "hedged" by securities comprising the index (such as in the case of certain bank issued certificates of deposit).

In analyzing these products, the touchstone must be investor protection. If there are potential concerns with the integrity of the underlying assets, the fairness of valuation for purchases and redemptions, the ability to engage in self-dealing or unsound capital structures, regulation under the 1940 Act is necessary and appropriate.

The Commission has taken this approach in the case of mini-accounts.[22] The Institute believes that products such as index participations merit the very same approach.

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[22] See SEC v. First National City Bank, SEC Litigation Release No. 4534 (Feb. 6, 1970).

III. SUBSTANTIVE REGULATION UNDER THE ACT

The drafters of the 1940 Act looked to the investment company industry as it existed in the late 1930's and enacted "good" structures and practices into law. For instance, in 1936, when the SEC began its study, the industry was dominated by closed-end funds, which held assets of over $1 billion, compared to open-end funds with assets of only $356 million. Closed-end funds generally were organized as corporations, and understandably, the drafters required all managed funds to have the corporate form of governance. Similarly, the industry in 1940 had few, if any, institutional funds. Thus, the Act was drafted to protect small retail investors. In addition, the drafters attempted to classify the various types of management companies that existed in 1940. This created a rigid dichotomy under the Act between open-end and closed-end funds.

By contrast, the investment company industry today is dominated by open-end funds; many funds are designed specifically for institutional investors; and the characteristics of new types of funds blur the traditional open-end/closed-end dichotomy.

It has, therefore, become increasingly clear that revisions are needed to the 1940 Act to accommodate these changes. We recommend adoption of amendments to the Act that would permit investment companies to: 1) operate under an alternative structure of governance; 2) offer certain fixed products not currently permitted; 3) offer funds that redeem their shares on a periodic basis; and 4) offer more flexible products for institutional investors. These recommendations are discussed below.

A. Unitary Investment Funds

The Institute recommends that funds be permitted to use as an optional governance structure, a unitary investment fund ("UIF") or contract type fund. It appears that the requirement under the Act that all managed investment companies be structured as corporations was not so much a reasoned decision of the drafters as it was a codification of existing conditions since, prior to 1940, the corporation was the almost universal form of the then dominant closed-end fund.

While the corporate form has clearly worked well for the past 50 years, it need not be the only form of governance that a fund may adopt. In most other countries, the unitary form is the predominant organizational structure for investment companies. The underpinning of the UIF structure is recognition that an investment company is, in many instances, a proprietary product chosen by investors on the basis of the manager's reputation, skill and services. To permit US funds to compete more effectively in the growing international markets, to increase efficiency and to reduce costs, US investment companies should have the option to adopt the UIF structure.

1. Structure

Although the specific details of the structure and operation of the UIF should be developed by the SEC and the industry at a later time, the following preliminary suggestions may be useful:

a) A UIF would be organized as a trust created under the terms of a document such as a trust indenture, which would set forth the terms governing the operation of the fund, including the fund's expenses, investment objectives and restrictions.

b) The fund would have an independent trustee to perform certain oversight and monitoring functions; however, the trustee would not serve as a substitute for the board of directors under the current regulatory scheme and shareholders would vote in only limited instances.

c) The UIF would be subject to the same prospectus disclosure and advertising requirements as any other investment company.

d) The core regulatory provisions of the Act, e.g., capital structure and self-dealing restrictions, would apply to UIFs as they do to corporate type funds.

2. Oversight

Under the UIF structure there would be very few, if any, specific items that would require direct trustee consideration. Matters that currently are reviewed by a fund's board would be detailed in the trust indenture. Thus, for example, the criteria to be followed by an investment adviser to a money market fund to comply with Rule 2a-7 would be detailed in the indenture. In certain specified areas, such as brokerage commissions discussed below, the trustee, which

would be independent of the manager, would have the obligation to exercise a specified oversight function.

3. Fees and Charges

All of the fees and expenses incurred in selling, distributing and operating a UIF, except for brokerage commissions and other variable expenses, such as transfer agent fees, would be fixed in the indenture as a specified percentage of assets, i.e., a "single fee", which would be disclosed to investors in the prospectus. Any change in the fixed fee would require an amendment to the trust indenture. Since the fee would represent, in simplest terms, the fixed expenses of a proprietary product, there would be no need for annual review of the advisory contract and the adviser's compensation. While investors would be concerned with the level of single fee, they should not be preoccupied with the appropriateness of a specific allocation between operating expenses and profits of the adviser. Thus, the provisions of Section 36(b) authorizing shareholder suits to challenge fees or any other management fee controls are inconsistent with the UIF structure. Moreover, there should be no arbitrary limit on any particular component of the single fee, such as the use of part of this fee for distribution expenses.

Front-end or deferred sales charges should be subject to the same limitations as those imposed on traditional corporate type funds, i.e., NASD regulation. Since these charges are paid by individual shareholders, and not out of fund assets, the organizational structure of the fund provides no reason to adopt different rules.

The only remaining concern relating to fees and charges under the UIF structure arises with respect to variable costs, such as brokerage commissions paid on the fund's portfolio transactions which, by their very nature, cannot be fixed. In the case of brokerage commissions, the Institute has identified two approaches that would limit potential abuse. Either the fund could be required to use only unaffiliated brokers or the trustee could be required to perform a similar oversight function as a board of directors under Rule 17e-1. Although an exception to the general rule that the trustee not function as a substitute for the board, we recommend the second alternative since a requirement to use unaffiliated brokers would not eliminate concerns about reciprocal agreements.

4. Amendments to the Trust Indenture

Material amendments to the trust indenture, such as changes in the fund's investment policy or an increase in the expense ratio or single fee, raise a further issue of investor protection under a UIF structure. There are two options for dealing with this issue. First, a vote of shareholders on a material amendment could be mandated. This is the approach used in Great Britain. Alternatively, the sponsor could unilaterally amend the indenture, provided that prior notice is given to shareholders. This would enable shareholders dissatisfied with the changes to redeem out of the fund (or sell their units, in the case of a closed-end UIF). Prospective investors would be put on notice through prospectus disclosure. While the second option would avoid costs to the fund, it may result in "friction" costs incurred by a shareholder, e.g., tax consequences upon redemption or sale and possibly a front-end or contingent deferred sales charge. Therefore, the best approach might be to limit the availability of the second option, at

least initially, to money market UIFs, since they are generally no-load funds and seek to maintain a stable net asset value.

B. Closed-End Unit Trusts

Currently, there are investment products (e.g., various types of asset-backed arrangements) that cannot comply with several of the provisions of the 1940 Act or qualify for an exemption and that, therefore, cannot be publicly offered. We believe that a closed-end fixed pool structure would provide fund sponsors with the vehicle that would allow them to offer those products to the public. For example, this would be an ideal structure for mortgage-backed and asset-backed pools, which have different classes for different cash flows and which do not issue redeemable shares.

Closed-end unit trusts could be accommodated easily under the Act by revising the definition of "unit investment trust" in Section 4(2) to delete the requirement that the trust issue redeemable securities.[23] Based on the historical concern that fixed, non-redeemable pools might be abandoned by their sponsors, the Act was drafted to permit unmanaged unit trusts only in open-end (redeemable) form. We believe that the safeguards contained in Section 26 of the Act adequately address the concern that sponsors of a closed-end unit trust might "abandon" the trust and leave investors with illiquid units. Section 26 limits the ability of a trustee to resign and authorizes the SEC to seek a court order to liquidate a trust if such action would be in the best interests of shareholders. It might be advisable to strengthen this safeguard by allowing the SEC

[23] A fixed portfolio could be organized as a UIF if our proposal discussed above is adopted.

to liquidate trusts administratively in specified circumstances. If, however, there remain problems with "orphan trusts", the SEC could also be authorized to establish certain minimum size or other standards (e.g., qualification for NASDAQ or stock exchange listing). If the trust falls below the minimum size or no longer qualifies for NASDAQ or stock exchange listing, it would become automatically redeemable.

A further change needed to permit the offering of closed-end funds with fixed portfolios organized in trust form is the modification of the restrictions on senior securities contained in Section 18. The history of the Act reveals that leveraging is restricted under this provision because funds often had capital structures that were too complex for investors to understand.[24] In addition, the Act's leveraging restrictions are more stringent for open-end funds than closed-end funds because the holders of senior securities in an open-end fund are in a more precarious position than the holders of similar securities in closed-end companies. The shareholders of open-end funds can redeem their shares at any time, leaving the senior security holders with no junior securities below them.

We believe that the closed-end unit trust would not give rise to these abuses. Because the trust's portfolio would be fixed, investors in these pools should be able to assess from the outset the complexity of the product and the risks that leveraging may present due to the fixed nature of the pool. Moreover, the shareholders holding the "junior" securities would not be able to redeem out of the fund. We, therefore, recommend relaxing the restrictions contained in Section 18 to

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[24] See, Hearings on S. 3580 before a Subcommittee of the Senate Committee on Banking and Currency, 76th Congress, 3rd Session 38 (1940) (statement of Robert E. Healy).

allow fixed closed-end pools to issue senior securities and to have multiple classes of securities to permit allocation of different types of income or expenses.[25]

C. Hybrid Open-End/Closed-End Funds

The 1940 Act created a rigid dichotomy between open-end funds and closed-end funds. The Act defines a "redeemable security" as a security under the terms of which the holder, at its option, may present it to the issuer and receive approximately his proportionate share of the issuer's current net assets.[26] Although the Act does not expressly define the term "current net assets", it has been interpreted by the SEC to mean each day's net assets.[27] Thus, a fund that does not offer daily redemptions must be registered and regulated as a closed-end fund. The SEC staff also has taken the position that a closed-end fund cannot make a commitment to

[25] We further recommend that the restrictions of Section 18 be relaxed with respect to open-end fixed pools, i.e., unit investment trusts, to permit different classes entitled to different allocations of income or expenses. Again, because the assets of the pool are fixed, an investor should be able to assess from the outset whether this type of product is too complex or risky. However, the restrictions on leveraging should remain in place, since the fund will be issuing shares that may be redeemed by the junior security holders.

[26] Section 2(a)(32).

[27] In 1969, the SEC formalized this position through rulemaking upon the adoption of Rule 22c-1(b), which states that "current net asset value shall be computed no less frequently than daily." Rule 2a-4, entitled "Definition of 'Current Net Asset Value' for use in Computing Periodically the Current Price of Redeemable Security" implies that the required frequency of net asset value computation is daily, but does not specifically define "current" as "daily".

purchase its shares through a tender offer at definite times or intervals.[28] The result is that a fund must offer redemptions either daily or never; there can be no middle ground.

The Institute recommends that the Act be revised to expressly permit periodic redemptions. It has been argued that periodic redemptions will reduce discounts to the net asset value of closed-end fund shares that exist in the secondary market. Whether this is the case over the long run is irrelevant. In the absence of any powerful counterveiling consideration, this change would permit the development of a range of innovative products. Many of these probably have not come to market because they are unable to maintain sufficient liquidity to meet daily redemptions, but do not want to register as closed-end funds.

There is no longer a need for the rigid distinction between open-end and closed-end funds. The underlying rationale for this dichotomy was the concern that investors might be confused regarding their right to redeem their shares. Apparently in the 1930's, there were funds that were represented as being redeemable, while in fact the boards of those funds would decide from time to time whether they were redeemable.[29] Today, investors are more knowledgeable about such matters as redeemability and are advised by a very active financial press. Thus, they are more apt to understand the concept of periodic redemptions. In addition, full disclosure

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[28] In the staff guidelines accompanying the proposed changes to Form N-2, the staff stated that a closed-end fund's board may agree to consider periodically whether to make a tender offer, but that the board may breach its fiduciary duty by affirmatively stating that the fund will make such offers at definite times or intervals in the future. See Investment Company Act Release No. 17091 (July 28, 1989), 54 FR 32992 (Aug. 11, 1989).

[29] See Hearings on S. 3580 Before a Subcomm. of the Sen. Comm. on Banking and Commerce, 76th Cong., 3d sess. 985-986 (1940).

would help insure that investors are not misled about the redemption features of the fund in which they invest.

To make it easier for investors to understand hybrid products and to clarify when shares may be redeemed, a hybrid fund should be permitted to redeem only at regular intervals (e.g., weekly, monthly, quarterly, etc., as opposed to every 13 days). Moreover, to avoid investor confusion, only funds that redeem daily should be permitted to call themselves "mutual funds." Other funds should be referred to as closed-end funds with periodic, e.g. quarterly, redemptions.

Hybrid funds could be accommodated fairly easily under the Act.[30] Although a new subclassification of management companies would have to be added to Section 5, these funds could be regulated either as open-end or closed-end funds, depending on the length of their redemption intervals. The Institute recommends that those funds redeeming shares more frequently than quarterly be treated as open-end funds for most regulatory purposes. Thus, for example, a hybrid fund that offers monthly redemptions would be treated as an open-end fund under those provisions of the Act that specifically prescribe limitations for open-end funds, such as Section 18(f) dealing with the issuance of senior securities. With the exception of rules relating to the distribution of fund shares, those hybrid funds that redeem quarterly or less frequently would be treated as closed-end funds.

[30] In order for hybrid funds to be offered, exemptive relief will be needed from Rule 10b-6 under the Securities Exchange Act of 1934 to permit these funds to periodically redeem their shares while making a continuous offering of their shares. (See, e.g., Prime Income Trust, SEC No-Action Letter, (Nov. 21, 1989).

Since hybrid funds that provide for periodic redemptions will need to seek new capital, they will presumably offer their shares on a continuous basis. To the extent that such funds will be distributing their shares in the same manner as open-end funds, they should be subject to the provisions of the Act regulating the distribution of open-end fund shares, such as Section 22(d), regardless of the length of their redemption intervals. Further, hybrid funds should be permitted to use their assets for sales-related expenses to the same extent as open-end funds. A nominal redemption fee to cover the costs associated with the redemption or an early withdrawal fee, similar to the contingent deferred sales charge imposed by open-end funds, also should be permitted. Other rules applicable to open-end funds that should be applied to all hybrid funds include those relating to exchange offers under Section 11 of the Act and Rule 11a-3, and the provisions of Rule 22c-1, which require an open-end fund to sell and redeem its shares on the basis of net asset value. Since the shares of these funds will be sold and redeemed at net asset value, the value of the remaining shares will not be diluted.

Hybrid funds that redeem on a quarterly or less frequent basis should be permitted to require shareholders to provide irrevocable notice that they will redeem their shares at the next redemption date. Such notices should be required to be given to the fund within a time frame adequate to allow the portfolio manager to obtain sufficient cash to meet redemptions.[31] The notice requirement would eliminate the need for SEC-imposed liquidity standards for these

[31] For example, funds with quarterly or semiannual redemptions could require notice one month in advance, and funds redeeming on an annual basis could require two months advance notice.

funds.[32] In addition, since the notice requirement would provide portfolio managers with a reasonable period of time to obtain sufficient cash to meet redemptions, periodic redemptions by hybrid funds should not have any greater effect on the marketplace than do redemptions of shares of open-end funds. With respect to open-end funds and hybrid funds that redeem their shares more frequently than quarterly, we recommend a liquidity requirement scaled to the period between redemptions to allow a non-daily redeeming fund to invest more than 10% of its assets in illiquid securities.

D. Institutional Funds

As a consequence of the drafters taking "snapshots" of the investment company industry as it existed in the late 1930's, the Act was designed to protect small individual investors. However, in recent years institutions and wealthy individuals have become major shareholders of investment companies. Indeed many investment companies are specifically designed for institutional investors. Examples of institutional investors include pension plans, corporations and depository institutions.

Pursuant to the theory similar to that underlying the exemptions from registration under Section 4(1) of the Securities Act and the safe harbors established under Regulation D and Rule 144A, these institutional investors do not need the same level of protection under the 1940 Act that is afforded to smaller retail investors. We therefore recommend the elimination or

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[32] In Investment Company Act Release No. 5847 (Oct. 21, 1969) the Commission stated that the prudent limit on any open-end fund's holdings of restricted securities or securities not having readily available market quotations would be ten percent. See also Guide 13 to Form N-1A.

modification of a number of the regulatory requirements of the Act for funds offered only to institutional investors. This would allow fund sponsors to offer to institutional investors innovative products, such as certain asset-backed arrangements, which may involve a higher level of risk or a more flexible capital structure than that appropriate for retail investors.

For these purposes, the definition of "institutional investor" should be modeled after the definition of the term "accredited investor" under Regulation D of the Securities Act.[33] This standard would not include an intermediary who simply pools the assets of small investors.

We also recommend that the modifications proposed for institutional funds serve as a "testing ground" for similar changes for funds offered to retail investors. A report to Congress on the advisability of extending some or all of those changes to funds offered to other investors should be mandated, after the SEC has had an opportunity to evaluate the impact of these proposals on institutional funds.

To implement this recommendation, the entire Act should be reviewed to determine which provisions should be modified for institutional investors. We have set forth below some

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[33] With respect to individual investors, Regulation D defines an "accredited investor" as any natural person whose individual net worth (or joint net worth with that person's spouse), at the time of purchase exceeds $1,000,000 or who had individual income in excess of $200,000 in each of the two most recent years (or joint income with that person's spouse in excess of $300,000) and has a reasonable expectation of reaching the same income level in the current year. Corporations, partnerships, employee benefit plans and other similar investors must have total assets in excess of $5,000,000 to be deemed an "accredited investor."

specific suggestions that are intended to serve as a starting point rather an exhaustive list of all possible modifications.[34]

1. Governance Structure

Funds which are sold only to institutional investors should have the option of adopting the UIF structure. Such a fund would not have a board of directors, and the shareholders would not have voting rights, except possibly in the limited circumstances discussed above when the sponsor proposes to make a material change to the trust indenture.

2. Capital Structure

The restrictions on capital structure contained in Section 18 of the Act should be eliminated for institutional funds. Such funds would thus be permitted to have different classes with different allocations of income or expenses and unlimited leveraging through the issuance of senior securities.

[34] Several of the recommendations also apply to funds available to all investors and are the subject of other recommendations contained in this statement. If our recommendations are not adopted for all funds, they should still be considered in connection with institutional funds.

3. Periodic Redemptions and Payment on Redemption

Institutional funds should be permitted to offer investors periodic redeemability and should not be subject to the requirement to pay redemption proceeds within seven days. In this regard, institutional funds also should not be subject to any restrictions on portfolio liquidity.

4. Affiliated Party Transactions

The Commission should consider granting exemptions under Section 17 for funds offered only to institutional investors. In doing so, the Commission should take into consideration the sophistication of these investors and the particular operations of the fund.[35]

E. Section 6(c)

Section 6(c) was put in the Act in recognition of the "snapshot" problem--without an administrative safety valve the industry would be frozen into a rigid inflexible structure. As Alfred Jaretzki commented in 1941 with respect to Section 6(c), "[w]ithout these exemptive powers and without a wise exercise of discretion thereunder, the Act would be unworkable, unduly restrictive, and would cause unnecessary hardships."[36]

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[35] The Institute further recommends that the Advisers Act be amended to permit advisers to institutional funds to charge any type of performance based advisory fee.

[36] Jaretzki, "The Investment Company Act of 1940," 26 Wash. U.L.Q. 303, at 344 (1941).

In recent years, the administration of Section 6(c) has caused the very "unnecessary hardships" that that section was designed to relieve. Although adoption of the suggestions for modernizing the Act made in this statement should relieve much of the current pressure for exemptive relief, we believe that certain new procedural provisions would enhance the efficiency of the exemptive process, conserve staff resources and mitigate the chilling effect of inordinate time delays. Therefore, while recommending no change to the exemptive authority granted the SEC under section 6(c),[37] we recommend the adoption of two provisions intended to ensure that exemptive applications are processed without undue delays.

The first such provision could state, for example, that any application for an exemption under Section 6(c) on file for more than 90 days would be deemed granted, if the Commission did not take any action during that 90-day period with respect to the application.[38] To further streamline the exemptive process, we also propose that exemptive orders have precedential value. Thus, any subsequent application for the same relief, subject to the same conditions as that granted in a previous order would be deemed granted 30 days after filing unless the staff raised an objection within that period. By contrast, however, we do not recommend any other change in the exemptive process, such as the elimination of the requirement for public notice.

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[37] If, however, our recommendations for modifying the Act are not adopted, we recommend that the SEC be provided with authority to grant class exemptions with respect to each of our specific proposals.

[38] This is the approach taken in Section 4(c) of the Bank Holding Company Act, which provides with respect to applications under Section 4(c)(8) thereof that "[i]n the event of the failure of the [Federal Reserve] Board to act on any application for an order . . . . within the ninety-one-day period which begins on the date of submission to the Board of the complete record on that application, the application shall be deemed to have been granted."

IV. DISTRIBUTION OF INVESTMENT COMPANY SECURITIES

The Institute urges the Commission to take a fresh look at the inappropriate restrictions placed on the distribution of mutual fund shares.[39] These restrictions are largely a result of the fact that, prior to the enactment of the 1940 Act, the industry was dominated by closed-end funds. Since closed-end funds "fit" under the 1933 Act, the drafters of the 1940 Act left to 1933 Act regulation the distribution of shares of all types of investment companies. Most of the shortcomings that exist in the area of distribution arise from the imposition of traditional Securities Act regulation on mutual funds, even though the sale of mutual fund shares is very different from the sale of shares of closed-end funds and other issuers.

For most corporations, including closed-end funds, the offer and sale of securities is an infrequent event, rather than a continuous process. Such issuers (unlike mutual funds) are subject to the restrictions of the 1933 Act only during those rare times that they are making public offerings. Perhaps more importantly, since mutual fund shares are redeemable on a daily basis, there must be continual sales simply in order to avoid self-liquidation.

In addition, the unique nature of mutual funds makes every sale of its shares an offering by an issuer, underwriter or dealer. Thus, unlike a purchase of other securities, including closed-

[39] Most of the recommendations contained in this part pertain only to open-end investment companies since they present unique problems under the federal securities laws. However, to the extent that the Commission adopts our recommendation contained in Part III.C to permit "hybrid" open-end/closed-end funds, our recommendations would be equally applicable to these types of funds.

end funds, a mutual fund investor can only purchase shares of the fund in a transaction that is subject to the Securities Act.

For these reasons, the sale of mutual funds shares is very different than the sale of most other securities. To the extent the 1940 Act covers distribution issues, it generally recognizes and makes provision for these differences. One example is Section 22(d). However, the Securities Act does not address the differences between mutual funds and other issuers. Although the Commission has, in the past, recognized the need for, and adopted, special rules for mutual funds under the Securities Act, the Institute believes that more needs to be done. Specifically, the Institute recommends revising the securities laws to permit mutual funds to 1) make written offers that would not be subject to prospectus liability, i.e., non-Rule 482 advertisements prior to prospectus delivery; and 2) include purchase applications in Rule 482 advertisements which are subject to prospectus liability. These proposals are discussed in Part B below.

A. Investment Company Act Issues

1. Section 22(d)

As noted above, the continued existence of a mutual fund is dependent on its ability to maintain a system for the continuous public distribution of its "product", the shares of the fund itself. It is, therefore, not surprising that the drafters of the 1940 Act sought to create a legal framework that would promote a distribution system capable of assuring the long-term viability

of an industry legally bound to honor redemption requests. Section 22(d) is meant to assure a stable, systematic and ongoing sales effort on the retail level. This allows funds to establish and maintain, insofar as possible, a continuous flow of new investors to replace those who redeem their shares.

In addition, Section 22(d) serves to prevent discrimination between buyers of mutual funds by ensuring that purchasers of mutual fund shares, whether using brokers or buying directly from the fund, are treated equally. In this manner, Section 22(d) eliminated the sales abuses that occurred in the 1930's. During that period, competition among dealers resulted in discrimination among customers, some of whom paid higher loads than others.

The true alternative to Section 22(d) would be a system of freely negotiated sales charges. Under such a system, smaller investors could be charged any load, if it were fully disclosed and did not violate the anti-fraud standards of Rule 10b-5. A return to a system permitting price discrimination such as that existing prior to 1940 would thus most severely impact smaller investors. In addition, the lack of a readily ascertainable public offering price is apt to cause confusion among all investors.

Experience indicates that Section 22(d) has worked well for 50 years. In fact, the system provides the investing public with a great variety of sales charges, ranging from the maximum permitted under NASD rules down to zero in the case of no-load funds. Indeed, all available data indicate that there <u>is</u> a great deal of price competition in the industry. Recent years have seen increases in the number of no-load funds and an increasing percentage of "low-load"

funds.[40] Since 1960, the effective sales rate, i.e., sales charges as a percentage of sales, has continued to decline.[41]

For these reasons, the Institute believes that Section 22(d) need not and should not be amended.

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[40] Of the universe of funds with a front-end load and no active 12b-1 plan, statistics show that the number of funds with a maximum sales load of 8.5 percent has decreased dramatically (from 341 funds with 80 percent of assets in 1972 to 159 funds with 60 percent of assets in 1983, and to 60 funds with 18 percent of assets in 1990). The category of front-end load charges that is most common today is the 3 percent to 6 percent category. As of September 1990, there were 275 funds with over $91 billion in this category, while in 1972 there were only 4 funds with assets of $190 million. The number of no-load funds has grown from 136 with assets of $5.1 billion in 1972, to 522 funds with assets of $134 billion in 1990.

[41] This decline is demonstrated by the results of surveys in 1971-72 by the NASD and Booz Allen Hamilton, Inc. and by the Institute in 1982 and 1990. All of the surveys covered funds with no active 12b-1 plans and front-end loads greater than 3 percent.

TRENDS IN AVERAGE SALES CHARGES
1960-1989

	New Sales	New Sales + Reinvestment of Dividends	Total Sales (incl. Exch.)
1960	7.0%	6.6%	6.3%
1961	6.9	6.5	6.2
1966	6.6	6.1	5.8
1968	6.0	5.7	5.4
1970	5.7	5.0	4.4
1982	4.9	4.2	3.5
1989	4.4	3.5	2.7

2. NASD Regulation of Sales Loads

The Institute believes that NASD regulation of front-end sales loads also has worked well. The maximum limits on sales loads established by the NASD help to guard against over-reaching, yet still permit flexibility. In this regard, such an approach is preferable to fixed statutory limits.

The Institute also believes that the introduction of contingent deferred sales loads, or CDSLs, has provided investors with a greater degree of choice and, for that reason, represents a positive development. Accordingly, the Institute continues to support those elements of proposed Rule 6c-10 that would codify prior CDSL exemptive orders. However, as noted in the Release, the Institute believes that implementation of the proposed non-contingent, installment sales load, would entail substantial operational burdens and costs.

3. Asset-Based Sales Loads

The use of fund assets to finance distribution costs, i.e., an asset-based sales load, is a valuable alternative to the traditional load/no-load dichotomy. It gives shareholders an opportunity to pay for their purchase of fund shares over time while having more of their money immediately put to work. Fund sponsors are given a flexible alternative to finance distribution costs. Moreover, as noted in the Release, many fund groups have responded to the preferences of some investors for choices in this area by requesting exemptive orders permitting "dual class"

funds, which permit a single fund to offer both shares with a traditional front-end load and shares with a spread load arrangement.

Given the use of 12b-1 plans as alternatives to traditional front-end loads, the Institute believes that regulation of these charges by the NASD is entirely proper. The NASD has proposed the adoption of a regulation governing the payment of asset-based sales charges by an investment company, which is designed to ensure that, in the aggregate, the amount charged to investors will not exceed the economic equivalent of the maximum permissible front-end charge.[42]

The Institute strongly supports the NASD proposal and believes it is preferable to attempting to impose an equivalence standard on a shareholder-by-shareholder basis, as under the Commission's proposed Rule 6c-10. As noted above, this would involve significant costs and operational burdens and, thus, is not a realistic alternative. Moreover, since financing distribution of its shares is a legitimate expense for a fund which must continuously sell shares to avoid liquidation, the Institute can see no reason why these expenses should be treated as an expense of each account rather than as fund expenses. By their very nature, mutual funds involve sharing of expenses and, therefore, costs of doing business should not be required, as a matter of law, to be "disaggregated". Freedom of investor choice within a context of adequate disclosure and a regulatory structure to prevent overreaching, similar to the traditional approach for the regulation of front-end sales charges, is the most appropriate method to address this issue.

[42] NASD Notice to Members No. 90-56 (Sept. 1990).

In conclusion, the Institute believes that a revised 1940 Act should continue to permit mutual funds to use fund assets to finance distribution expenses. The proper means to regulate such payments is the same as used for front-end sales loads, NASD regulation.

B. Securities Act Issues

1. Advertising

The overly restrictive nature of the Securities Act's limits on advertising as they pertain to mutual funds arises from the requirement that no written offer may precede delivery of a prospectus meeting the requirements of Section 10. As a result, mutual fund advertisements have been subject to restrictions not imposed on the offering of competing financial products, such as bank deposits and insurance contracts. In recognition of this problem, the Commission has, in the past, permitted funds greater latitude than other issuers in the offering of their securities.

When adopted in 1955, Rule 134 under the Securities Act (governing so-called "tombstone" advertisements) allowed investment companies to include only minimal information. The Commission has since amended Rule 134 several times to expand the type of information that investment companies may include.[43] However, the content of Rule 134 ads

[43] In adopting one such amendment in 1974, the Commission noted "these steps reflect the fact that mutual fund distribution differs in many ways from the underwriting of other securities and that investment companies are subject to comprehensive regulation under the Investment Company Act of 1940". Release No. 33-5536, IC-8568 (Nov. 4, 1974).

remains severely circumscribed. Most significantly, they cannot include performance or yield information.

In 1979, the Commission withdrew its "Statement of Policy", which had served as a rigid advertising code, and proposed to replace it with Rule 156, adopted several months later. Rule 156 applied general anti-fraud standards to mutual fund advertising and sales literature. In the interim, the Commission adopted Rule 434d (later Rule 482), which permitted performance information in certain advertisements, provided the information was not misleading and the substance of the information was contained in the fund's prospectus. Rule 482 has since been amended several times.

The Institute believes that these actions by the Commission have been extremely helpful. It is not accidental that industry assets increased dramatically in the years following the liberalization of the advertising rules (and the adoption of Rule 12b-1).[44] However, more can and should be done. Since Rule 482 allows only information the substance of which appears in a fund's full prospectus, funds are forced to include otherwise unnecessary information in their prospectuses, solely to maintain flexibility in advertising. In addition, funds are subject to prospectus liability under Section 12(2) of the Securities Act for Rule 482 advertisements.

Thus, under current law, mutual funds are restricted in their advertising in a way that most other providers of financial services are not. In addition, the current rules have the effect of distinguishing between directly marketed (e.g., no-load) funds, which rely almost exclusively on

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[44] As of year end 1980, total assets for open-end investment companies reporting to the Institute equalled $134.7 billion. As of August 1990, the total assets were $1,064 billion.

written advertising and sales literature, and those sold through brokers, which rely more on oral offers. Most oral offers are not subject to the Securities Act restrictions, other than anti-fraud liability, since they are not prospectuses.

The Institute believes that these anomalies should be addressed by revising the securities laws to permit mutual funds to make written offers that would not be subject to prospectus liability prior to prospectus delivery. This change would have the effect of equating written offers with oral offers made by brokers. In addition, it would place funds on a more equal footing with other financial products.[45]

2. "Off the Page" Sales

The Institute also proposes to allow "off the page" sales by permitting Rule 482 advertisements, which are subject to prospectus liability and contain only information the substance of which appears in the fund's full prospectus, to include purchase applications. An investor could respond directly to the advertisement by sending in the completed application along with a check. The fund's prospectus would be delivered along with the confirmation.

Allowing "off the page" sales would permit mutual funds to compete on a more equal basis with other financial products sold in a similar manner and would further equalize written and oral offers of fund shares. The ability to sell "off the page" could also reduce costs for funds

[45] While the Institute believes that these written offers should not be regulated as "prospectuses", it supports granting the Commission authority over the content of written advertisements. For example, the Commission still could require yields to be computed in a standardized fashion and that certain legends be included in written advertisements.

which currently send substantial numbers of prospectuses to investors with little serious interest in investing. Most importantly, the Institute believes that "off the page" sales could be permitted without sacrificing the protection of investors. The Commission would have the authority to regulate the content of any Rule 482 advertisement containing a purchase application. Moreover, investors would receive a full prospectus with the confirmation, as in the case of purchases through brokers. Finally, the fact, noted in the Release, that other jurisdictions, including the United Kingdom, allow "off the page" sales demonstrates that such a system is feasible.

The Institute believes that investors purchasing mutual fund shares directly from an advertisement should be allowed to rescind the purchase within a specified period of time (e.g., mailing time plus five days) in order to allow them to review the full prospectus. This raises the question of how to protect investors who rescind their purchases from "friction costs", which can arise from sales charges and changes in a fund's net asset value. There are two possible approaches. One would be to adopt a system under which investors would assume the risk of any fluctuation in share prices during the waiting period, but any sales charge would be returned. Presumably if this approach were adopted, a prominent legend would be required to be included in the advertisement. Alternatively, the purchase amount could be held in escrow and not invested until the close of the waiting period.

3. Prospectus Delivery

The Release requests comments on whether, in the case of dealer sales, prospectus delivery should be required before the sale is consummated. The Institute strongly opposes this suggestion, for two reasons.

First, it is difficult to understand why sales of mutual funds should be subject to a stricter requirement than sales of other securities requiring prospectus delivery. Mutual funds are subject to a much higher degree of regulation than other issuers, which, if anything, should lead to less of a concern in this area.

Second, if adopted, brokers would have to adopt completely different sales systems for shares of mutual funds, as opposed to other securities. This could create severe operational difficulties for brokers, especially since the same customer may be invested in mutual fund shares and other securities.

Perhaps if there was evidence of abuse and harm to investors as a result of the current prospectus delivery requirements, such a radical revision to the securities laws might be warranted. However, the Institute is not aware of any such evidence.

C. Unit Investment Trust Secondary Market Sales

The Commission has taken the position that the term "issuer" under the 1933 Act includes a unit investment trust sponsor maintaining a secondary market in trust units. Thus, the sponsor, as long as it maintains such market, must file post-effective amendments annually to update the registration statement for the series. In addition, as noted in the Release, sponsors and third party dealers are required to deliver a current prospectus to investors in connection with secondary market sales. Although the updating and delivery requirements impose burdens on sponsors of unit investment trusts, the Institute believes that investors benefit from the delivery of relevant information about the trust in which they are investing. However, as the Institute has previously commented, the current updating and delivery requirements impose substantial costs and burdens far beyond the benefits to investors.[46]

When the Institute examined this issue several years ago, an informal survey indicated that auditing and printing costs together constitute a major portion of the total cost to sponsors of updating registration statements. Substantial internal resources also are devoted to the updating process. As the Institute noted in its comment letter on reproposed Form N-7,[47] certain changes to the requirements for updating unit investment trust registration statements could significantly reduce the costs associated with secondary market prospectus delivery. For example, the Institute suggested that use of a two-part prospectus (one series-specific and the other containing generic information about the trust), combined with (1) the ability to incorporate by reference

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[46] Comment Letter of the Investment Company Institute on Reproposal of Form N-7, File No. S7-9-87, dated May 15, 1987.

[47] Id.

into post-effective amendments the generic portion of the prospectus, and (2) the ability to satisfy prospectus delivery requirements with respect to secondary sales by providing only the trustee's annual report supplemented as necessary with other material information. The Institute also proposed that unit investment trusts meeting certain conditions be required to include audited financial statements only in the initial offering prospectus and in any updated prospectus or annual report delivered within a period of eleven to eighteen months after the initial offering. Thereafter, unaudited financial statements would be permitted.

The Institute continues to believe that the approach of reproposed Form N-7, as modified in accordance with the Institute's recommendations set forth in its May 15, 1987 comment letter, would achieve significant cost savings for unit investment trust sponsors without compromising investor protection. Moreover, this approach could be implemented with little additional delay, as the revised Form N-7 has been proposed for comment twice and presumably could be adopted by the Commission with the suggested revisions in the near future.

V. INTERNATIONALIZATION OF INVESTMENT COMPANY SALES

A major development not contemplated in 1940 is the recent internationalization of the world's securities markets. Technological advances, such as the ability to trade securities 24 hours a day worldwide, have made global securities markets a reality.

From the perspective of the US investment company industry, internationalization of investment company markets is an attractive goal and, for several reasons, the export of the US industry abroad makes sense. As Chairman Breeden has noted with respect to US funds "[w]e have the best products in the world in that area." International growth is a logical next step for an industry that has experienced substantial success in its domestic markets and is highly respected throughout the world.

Moreover, consumers everywhere stand to benefit through expansion of the investment opportunities available to them: investors overseas would benefit through the ability to invest in US funds and US investors would benefit if foreign funds were available to them. As further discussed below, however, the regulatory schemes in effect in the US and abroad, as well as certain other obstacles, currently prevent effective international competition in investment company markets.

A. US Investment Companies Selling Abroad

Historically, the US investment company industry has had limited success in its attempts to enter foreign markets. Sales of US mutual fund shares abroad account for less than one percent of industry assets. Experience has shown that there are numerous obstacles to effective market access abroad. Such obstacles include barriers imposed by both foreign regulatory schemes and marketing and distribution systems, as well as certain US tax law provisions.

In the European market, for example, there are several countries, such as the United Kingdom and France, in which it generally is not possible for a US fund to register and sell its shares.[48] One reason for this problem is that the current regulatory schemes in those countries simply do not accommodate US funds in their traditional legal form. While the 1940 Act requires management investment companies to be organized as corporations or business trusts, the predominant form of investment company in Europe is analogous to a common law trust, which may have a trustee/depository but not a board of directors. Thus, the accommodation of US funds in some European countries will require recognition that our system of governance through a corporate board of directors provides the functional equivalent of the role of the trustee/depository or similar third party responsible for safeguarding investor interests in many European funds.[49]

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[48] Similarly, in Japan, the tight control maintained by the Japanese government over the Japanese securities markets has effectively denied access to US funds and fund managers.

[49] Our proposals for increased flexibility, such as the recommendation to permit the creation of "unitary investment funds" discussed in Part III.A could alleviate this problem.

In addition to these legal and structural impediments to European market access, there are practical obstacles facing US funds that seek to compete in Europe, such as the inability to gain effective access to distribution channels. This problem results, for example, from the domination of some markets by major banks selling their own mutual fund products. It is compounded by the fragmentation of the European market into 12 different nations with different marketing rules and practices.

Finally, another significant barrier to the international competitiveness of US investment companies is imposed by certain provisions of US tax law, discussed in greater detail below, which currently create major disincentives for most potential foreign investors in US funds.

B. Foreign Investment Companies Selling in the US

A foreign investment company seeking to sell its securities in the US is subject to Section 7(d) of the 1940 Act. This provision prohibits a foreign investment company from publicly offering its shares in the US unless the Commission issues an order finding that "it is both legally and practically feasible effectively to enforce the provisions of [the 1940 Act] against such company." Thus, a foreign fund must meet investor protection standards essentially identical to those applicable to US funds. In practice, Section 7(d) acts as a barrier preventing most foreign funds from selling shares in the US.

C. Negotiation of Treaties Providing for Investor Protection and Effective Market Access

In developing a strategy for eliminating the barriers discussed above, there are two primary considerations.

First, it must be clear that US investors in foreign funds will be adequately protected through the application of regulatory regimes that are comparable in all material respects to that of the 1940 Act. As discussed in Part II above, the core policy concerns that the 1940 Act is meant to address apply in the case of any publicly-offered securities pool.

Second, any opening of the US market to foreign investment companies must be accompanied by a corresponding opportunity giving US investment companies effective market access abroad. In this regard, it is not surprising that the SEC's 1984 proposal to amend Section 7(d) had no Congressional sponsor. That proposal would have provided an unfair and unjustified one-way street, by relaxing the restrictions of Section 7(d) to permit more foreign investment companies to compete in the US market, without providing for US investment companies' reciprocal access to foreign markets.

With the above two considerations in mind, we believe that the best approach to facilitating international competition in investment company markets is through negotiating individual treaties or bilateral agreements with other countries or groups of countries. Any such treaty should seek to ensure both adequate investor protection and equal market access. Once it

has been established that the regulatory system of a potential treaty partner provides an adequate level of investor protection, it may be possible to follow the home country rule approach taken by the European Community's directive on "undertakings for collective investment in transferable securities" or "UCITS." Under that approach, the regulatory system in the home country of the investment company, possibly supplemented by a limited number of additional conditions, would be recognized as providing adequate investor protection to shareholders in the host country.

The harmonization approach of the UCITS directive is a positive development in the European market that represents an important opportunity for the US investment company industry. Since 1987, representatives of the US industry have been engaged in ongoing discussions with EC industry leaders regarding the feasibility of a reciprocity agreement, modeled on the UCITS directive, that would permit US funds to be sold in Europe and European funds to be sold here. Our goal in these discussions has been to provide for effective market access for US and European funds while assuring investor protection on both sides of the Atlantic. Both the Commission and the Treasury Department have been supportive of our efforts in these discussions.

Our discussions with the Europeans could serve as a model for the strategy we recommend for achieving increased internationalization of investment company markets. This approach has several advantages. First, a treaty or bilateral agreement providing for cross-border sales by funds organized in a particular country or group of countries that meet prescribed investor protection standards would be much easier to administer than Section 7(d), which

currently requires the Commission to consider foreign applicants on a fund-by-fund basis. Moreover, as under the UCITS directive, regulators in the home country of a particular fund would be responsible for ensuring compliance with the terms of an applicable treaty or agreement. Thus, each home country would be responsible for regulating the structure and operations of investment companies qualifying under the terms of the treaty or agreement, although the host country would regulate sales and marketing practices. This approach should help to assure adequate protection to investors residing in both treaty markets while providing the ability to negotiate for the simultaneous opening of these markets.

D. Remaining Barriers

Although we believe the above approach to internationalization holds the most potential for success, there remain two further structural barriers to cross-border marketing of investment company shares. First, US tax law currently provides a significant disincentive for foreign investment in US funds. Second, for foreign investment companies seeking to sell their shares in the US, state blue sky laws are an additional obstacle.

Foreign investment in a US fund is discouraged by the combination of the Internal Revenue Code's current distribution requirement and the 15 - 30 percent withholding requirement imposed on mutual fund dividends. Many foreign jurisdictions do not require current distributions of earnings by funds located within their territory, and many impose either no tax or a very favorable tax rate on realized capital gains. Thus, the earnings of a foreigner investing in a foreign fund, in many instances, are treated as a nontaxable capital gain. By

contrast, a foreign investor in a US fund will be subject to a 15 - 30 percent withholding tax each year on essentially all the fund's ordinary income and short-term capital gain.

Other disincentives to foreign investment in US mutual funds are created by the inability of a US fund to flow through portfolio interest and short-term capital gain to its shareholders. Since both portfolio interest and short-term gain are free from US withholding when paid to a foreign fund, a foreign investor has another strong incentive to invest in the foreign fund rather than a US fund, which must currently distribute portfolio interest and short-term gain as dividends subject to withholding.

We believe that current tax provisions, which render American funds with performance characteristics equal to their foreign competitors as clearly inferior products, are unintended barriers arising primarily from domestic principles of taxation that are increasingly inapposite on the international scene. To allow US mutual funds to compete in international markets, the guiding principle should be to place foreign investors in US funds in the same tax position as if these investors purchased their own country's domestic funds. The Institute is developing legislative proposals to amend those provisions of domestic tax law that create competitive barriers and is pursuing their enactment.

On the other side of the coin, state blue sky laws may serve as a significant barrier to foreign investment companies seeking to sell their shares in the US. Such funds would be required to register and comply with applicable state laws in all states in which they wished to offer their shares. Thus, not only would a foreign investment company be _______ to satisfy the

requirements of its home ________ and an international reciprocity agreement, but in addition, the requirements of fifty states.

It should be noted that state blue sky regulation also inhibits the sales of US investment company shares. Even though investment companies are extensively regulated at the federal level, the vast majority of states also regulate investment companies, often in an inconsistent and non-uniform manner.

Over the years, the Institute has worked with the individual state regulators and the North American Securities Administrators Association, Inc. ("NASAA") in an attempt to achieve uniformity at the state level and conformity to federal law on issues relating to substantive regulation and disclosure by investment companies. For example, in 1983, the Institute submitted a comment letter and testified at a joint SEC/NASAA hearing on issues relating to state regulation of mutual funds and unit trusts. In response to the testimony, NASAA adopted five resolutions in 1984 and two resolutions in 1985 urging states to suspend or repeal their expense limitations and to adopt uniform procedures in the areas of sales literature filing requirements, registration, amendment and renewal requirements, sales reporting requirements and oversales. Unfortunately, many states have not followed NASAA's recommendations. Thus, it is apparent that additional steps need to be taken by the SEC, NASAA and the individual states.

VI. ADDITIONAL LEGISLATIVE PROPOSALS

In addition to the topic areas covered above, there are a number of other items worthy of consideration in any review of the statutory system applicable to investment companies. While some of these issues were raised in the Release, others were not.

A. Regulation of Advisory Compensation

In 1970 Congress added section 36(b) to the 1940 Act. Under this provision, any shareholder may bring suit against the fund and its adviser alleging that the adviser has breached a "fiduciary duty" to the fund with respect to compensation paid by the fund to the adviser. This is a unique provision of the law having no counterpart for any other financial product. It has spawned numerous strike suits alleging that management fees are too high and involving fund organizations in time-consuming, costly litigation. While no plaintiff has ever prevailed, practical considerations have led many defendants to settle the litigation when the expense, effort and time involved in the defense became too significant to justify, notwithstanding the ultimate likelihood of success.

We recommend that section 36(b) be amended to deter frivolous suits and provide a more reasonable burden of proof to be applied in strike suit litigation. Specifically, the plaintiff should have the duty of proving a breach of fiduciary duty "by clear and convincing evidence". In addition, the courts should be permitted to award to the prevailing party the costs of maintaining or defending the action, including litigation expenses and reasonable attorneys' fees, upon a

finding that any claim or defense "was not based upon a good faith belief, formed after reasonable inquiry, that such claim or defense was well-grounded in fact and fairly warranted under this subsection." Upon application by any party to the litigation, the proponent of any claim or defense should also be required by the court to post a bond sufficient to cover the costs of the litigation.

B. Conforming Book and Tax Accounting

Current differences between Regulation S-X and tax accounting can result in book/tax differences in fund financial reports and share price computations causing confusion for shareholders and additional complexity for fund accountants. Since shareholders are ultimately concerned with the tax implications of their investments, tax accounting should be followed for all purposes, including share price computation and all financial reporting.

C. Riskless Principal Transactions

Section 17(a) of the 1940 Act currently prohibits a fund from engaging in all principal transactions with an affiliate, including so-called riskless principal transactions. These back-to-back transactions, as in the case of a fund buying a security from a broker who is simultaneously acquiring that security from another party, do not present the possibilities for abuse found in classic principal transactions. The affiliate is acting like an agent, but because of clearing and trading practices in the market, the transaction is structured so that title momentarily passes through the affiliate. As these transactions more closely resemble agency transactions, they

should be permitted and regulated under section 17(e) provided the mark-up on the trade is disclosed on the confirmation.

D. Series Companies

As a general matter, the substantive regulatory provisions of the 1940 Act should apply to the separate series of an investment company on an individual portfolio basis. However, to the extent funds may realize economies through, for example, the use of a single prospectus, the same board of directors,[50] auditors and combined proxy materials, such practices should be permitted.

E. Size of Investment Companies

According to the legislative history of the Act, the $100,000 seed money requirement of Section 14 was designed to take every "fly-by-night" sponsor "out of the picture."[51] In recent years, a concern has been raised that this requirement may no longer satisfy its original intent.[52]

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50 State corporate law may require a fund organized as a single corporation to have the same board of directors for all series of the fund.

51 Hearings on H.R. 10065 before a Subcommittee of the House Committee on Interstate and Foreign Commerce, 76th Congress, 3rd Session 116-117 (1940) (statement of David Schenker).

52 In response to concerns raised by the Director of the Division of Investment Management about the adequacy of the current requirement, the Institute submitted a letter recommending the approach outlined below. See Letter to Kathryn McGrath from Matthew P. Fink, dated July 1, 1988.

One way to alleviate this concern would be to require an investment company sponsor to have a minimum net worth. We believe that a minimum net worth requirement of $1,000,000 for a sponsor commencing a public offering of investment company securities would help achieve the intended goals of Section 14.

An alternative would be to increase the existing seed money requirement from $100,000 to $1,000,000. However, there are certain problems with this approach. First, fund sponsors often are unable to redeem their investment in a fund because of a mandatory accounting policy which would penalize such redemptions unless all organization expenses of the fund have been amortized.[53] The burden imposed on funds by this requirement would be greatly magnified if the seed money requirement were increased. Second, such an increase would require experienced and well-capitalized sponsors to commit more capital to each new investment company than would otherwise be warranted by the public policy concerns that led to the adoption of the seed money requirement. However, this problem could be alleviated by increasing the seed money requirement from $100,000 to $1,000,000 for the first investment company, but not for subsequent investment companies, offered by that sponsor.

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[53] SEC examiners routinely require a footnote to the seed money balance sheet which is designed to penalize the initial investor(s) for redeeming before the organization expenses are fully amortized. Organization expenses that have been advanced by the sponsor are carried as an asset and must be footnoted. The footnote states that the organization expenses will be amortized on the straight-line basis over a period of 60 months. In addition, language similar to the following is also required:

> "In the event any of the initial shares are redeemed prior to the complete amortization of the organization costs, the proceeds of the redemption payable in respect of such shares shall be reduced by the pro rata share (based upon the proportionate share of the initial shares redeemed to the total number of initial shares outstanding at the time of such redemption) of the unamortized deferred organization expenses as of the date of such redemption."

F. Options and Futures Transactions

Many funds that engage in options and futures transactions currently must limit such investments to "hedging" transactions, the extent of which is not always entirely clear, or be required to register as commodity pool operators with the CFTC. Thus, investment companies are generally unable to engage in various risk management techniques involving futures and options even though these techniques are be fully consistent with their investment policies.[54]

The broader issue of the regulation of financial futures is beyond the scope of the Release and this statement. However, the Institute urges that the Commission work with the CFTC to develop guidelines that would ensure that pools offered to the public register either as investment companies under the Investment Company Act or as commodity pools with the CFTC. We recommend that pools invested primarily in securities be regulated only by the SEC, while pools invested primarily in commodities be subject to exclusive CFTC jurisdiction. Of course, an SEC-registered fund would still be required to satisfy large trader reporting and other market regulatory requirements with respect to any exchange on which it engaged in transactions.

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[54] For example, an asset allocation fund that wishes to invest in the equity market might be able to do so on a less costly basis if it initially purchases stock index futures rather than individual stocks. However, if this investment did not satisfy the hedging requirement, the fund would be precluded from doing so absent CFTC registration.