

SEC HISTORICAL SOCIETY ANNUAL MEETING
June 5, 2008

DAVID MARTIN: Hello and welcome to everybody here in the SEC auditorium and mostly importantly to everybody listening to us online at www.sechistorical.org. My name is David Martin and I am the 2008-2009 President of the Board of Trustees of the SEC Historical Society. I would like to welcome you on behalf of the Board of Trustees and extend a sincere welcome to this our 9th annual meeting.

Before we start our meeting, I would like to say a word of thanks to the SEC and a brief introduction regarding the Society. We are a completely independent of the government, receive no government funding and are not connected to SEC in any legal way but our Board of Trustees deeply appreciates the friendship and hospitality that the SEC has extended to us for these programs and really through the life and mission of our Society. Particularly we would like to say thank you to SEC Chairman Christopher Cox who has been a big supporter, has come to many of our events and has been very helpful in having our programs extended to the SEC throughout the country. I would also like to say a congratulations to some of our volunteer leaders who are being called to a higher order, if you will, Elisse Walter from our Board of Trustees and Troy Paredes, who is a member of our Museum Committee, who sat in conformation hearings earlier this week and now are preparing now to become Commissioners of the SEC.

Let me say a word about the SEC Historical Society. Our mission is to preserve and share the history of the SEC and the securities industry and we do this through our virtual museum which many of you are on right now. I hope you all will continue to visit our museum. It is open 24 hours a day, seven days a week, and we get over 10,000 visitors every month. The museum is growing before our eyes.

We are in the midst of a celebration of the SEC's 75th anniversary. Today's program is one in a series on the major divisions of the SEC. This series began last November with "Keeping the Markets Open: Lessons Learnt from the 1987 Market Break" on what was then known as the Division of Market Regulation. Since that time, we have had Fireside Chats on the Office of the General Counsel, the Office of International Affairs and on the Regional Offices. We will pick up in the fall with programs on the Division of Enforcement; the Office of Compliance, Inspections and Examinations; the Division of Corporation Finance; the Office of the Chief Accountant; and the Office of the Chairman. This commemoration will culminate next June with our 10th Annual Meeting with a program entitled, 'Let's Not Take the SEC for Granted' and finally with a 75th anniversary gala dinner on June 25th, 2009.

As part of this commemoration year we, the Society has been able to celebrate with the SEC across the country. We have hosted ice-cream socials in Atlanta, Boston and Denver; we will be in Philadelphia later this month; and we intend to visit all the regional offices. Today, for those of you that are here at our ninth Annual Meeting there will be an ice-cream social. And so a word of thanks to our trustees, our advisors, our donors, our sponsors and our supporters everywhere for making all of what we are doing possible and for being here today with us.

Let me start with today's program, "Exemptive Authority: The Mandate of the Division of Investment Management," and I have to say that we couldn't be luckier to have a chair

and moderator of the ilk of Martin Lybecker of the firm, Wilmer, Cutler, Pickering, Hale and Dorr LLP and also a member of our Board of Advisors. I think most of you know that Marty is really a true luminary in the 40 Act Bar. He has really a deep history and deep experience in this area, which include 25 years or more of private practice, a number of years here at the SEC in service including as an associate director, and as a professor at a number of law schools, including Georgetown, Duke and the University of North Carolina. So we are really in very good hands. I would like now to raise the curtain on this program by introducing Marty Lybecker to you, and Marty then you could perhaps introduce your distinguished panel.

MARTIN LYBECKER: Thank you, David. I am pleased to welcome you all today to the program on the work of the Division of Investment Management. It was our choice to focus on exemptive authority because it is one of the really unique aspects of the Division, as I will explain. I need to thank Bob Plaze who is sitting to my left, and who is an associate director in the Division, for all of his help in planning this program and making it come together. I also need to thank Ken Berman, a partner at Debevoise, who is to my immediate right and Kathleen Moriarty, a partner at Katten Munchen, who is to my far right, for joining us and sharing their experiences and their expertise.

As is typical, in things that relate to the SEC, before we begin our discussion I would like to state that the comments we make today are our own and not representative of the SEC Historical Society or the US Securities and Exchange Commission. I am also required to say our speakers cannot give legal or investment advice. I am not sure why I have to say that, since we are all lawyers, but I've said it.

The premise of this program is that, beyond the actual prohibitions and the investor protections that are written into the Investment Company Act, the genius of this statute is that the draftsman inserted exemptive authority in various provisions of the Act. I think it is fair to say that, without that exemptive authority, the Investment Company Act would have become irrelevant or at least the investment company industry would have become irrelevant by 1960 or 1970. Instead, we have a vibrant investment management industry, investors enjoy access to variable annuities, money market funds, multiple classes, funds of funds, ETFs, all of which wouldn't have happened without the existence and use of this exemptive authority, and they have the opportunity to select among classes which allows them to pay fees for services in a variety of ways.

The first premise is that use of exemptive authority is unique within the Commission to the Division of Investment Management. The second premise is that, in administering the Investment Company Act, both the Commission and the Division staff have been influenced in the way they have dealt with issues by the fact that they had that kind of exemptive authority. There is no other Division or Office that, over the history of the Commission, has always had that kind of tool. So from my perspective, the fact of having exemptive authority has always made working with and being involved in the Division's affairs quite a unique experience. I thank David for his kind remarks, but I am pretty sure the only reason I am here is because I am one of the few people in this room who actually worked at the Commission's offices when they were at 500 North Capitol Street. The rest of you probably started at 450 Fifth Street. When I was in the Division, I actually knew people who had worked at the SEC offices on E Street after World War II, and we all knew some people who worked in the SEC's office in Philadelphia during World War II because it was deemed a "non-essential" agency. I guess, if you live long enough, you can say things like that.

We have divided the program into six big topics and I will tell you what everybody is going to talk about so you can see where we are headed. Bob Plaze is going to describe the various exemptive provisions in the Investment Company Act and you will quickly realize that Congress littered the Investment Company Act with different exemptive provisions that say different things for different purposes. Each such section requires that specific findings have to be made, so Ken is going to talk about the nature of the findings, and what the Division has to do to issue an order. I get to describe what happens if the Division can't issue an order; that is, the Division can't make the findings, the Division doesn't like the application, or even worse in some respects, the Division likes the application but there has been a request for a hearing -- or the Division has decided to recommend that the Commission set it down for a hearing -- and all of a sudden a lot of the Division's resources have to be devoted to prosecuting a hearing before an administrative law judge. The fifth group of issues we will talk about is, what are the implications to the Division and how it handles matters as a result of having exemptive authority. So I will talk briefly about the effect having exemptive authority has had on decisions regarding the issuance of no-action letters, the effect it has had on adoption of rules, and what the Division has done when it gets unwanted applications. If the benefit of having exemptive authority like that in Section 6(c) and the other exemptive provisions is that the SEC can use that authority to do good things, the bane, of course, is that any idiot with a 42 cent stamp can send in an application that the Division will actually have to deal with, so there is the negative aspect of having people whose issues you don't like actually dictate the SEC staff's agenda, which was always a frustration. Bob then is going to discuss what happens when there is actually a request for a hearing, and between the four of us, we came up with some good examples of certain unusual things that have happened. And then, at the end, we will wrap up with "war stories." We will go through some of the applications which resulted in hearings or were otherwise controversial, and how they ended up with becoming rules.

If we were speaking to a group of people who were just graduating from law school and they didn't know anything about exemptive applications and orders, they would be surprised at how much of the "law" about the Investment Company Act is contained in the applications that the Division has processed down through time by issuing exemptive orders.

So, that's the premise of the program and, Bob, you get to go first.

ROBERT PLAZE: Thanks Marty. I think you are right. Your description of the exemptive program and how important it is to development of the law is quite accurate. The Division staff doesn't have to go out and ask people where work needs to be done, where the Act is imposing unnecessary encumbrances on the business. We can just talk to the staff who are reviewing the applications and take a look at the numbers. We have a feedback loop from the industry as to provisions of the statute that provide problems with the development of the industry and a mechanism by which we can shape the statute to fit the future. In this way, a statute that was adopted so many years ago, in 1940, can be relevant to a dynamic marketplace that has changed tremendously since that time. Now, as Marty mentioned, there are multiple sources of exemptive authority in the statute but, as exciting as it would be to review each one of them, I am not going to have time to do that. But I am going to break them up into some categories and describe a few highlights of them -- to give you a feel for them and perhaps describe some of the issues that result from there being multiple sources of exemptive authority. These are

issues the answer to which we take for granted today but in 1940 with this brand new statute, there were some really head scratching issues that the staff and the Commission had to resolve.

There are two types of exemptive authority - one is the broad exemptive authority of Section 6(c) of the Act and its counterpart, Section 206A of the Advisers Act. The second is the specialized exemptive provisions that are embedded within certain provisions of the Act and sometimes essentially overlap with Section 6(c) of the Act. The exemptive authority provisions typically not only provide the Commission with the authority to issue orders providing individualized exemptive relief, but also provide rule making authority -- broad rule making authority. And yes, the staff does have a process by which we are eventually codify the orders into rules and make them available to a broader set of applicants which do not need to apply for an order. Of course the procedures for issuing orders and the procedures for issuing rules are significantly different; we have to go through a public notice and comment process which is a bit different than the hearing request process we will talk about in a little while.

Now as I mentioned the quintessential exemptive provision is Section 6(c) of the Investment Company Act. Section 6(c) is the model Congress used when it later provided the Commission with additional exemptive authority. It is the original exemptive authority provision. The Advisers Act authority in Section 206A didn't come along until 1970 and it was modeled after Section 6(c). The exemptive authority the Commission has under the '33 and '34 Acts that were added by NSMIA in 1996 -- as you can see, much later. These provisions were also based on Section 6(c) so you can see this one provision that was written in 1940 has had an effect not only within the Investment Company Act but the other securities laws we administered. Interestingly, under the '33 Act, the provision is modified slightly from Section 6(c). We only have rulemaking authority under the '33 Act -- not the authority to issue individualized exemptive orders.

Back to Section 6(c). Under Section 6(c), the SEC may conditionally or unconditionally exempt any person, security or transaction from any rule or provision of the Act -- that's *any* rule or provision. Now there are certain provisions we traditionally don't provide relief for. If you were thinking of coming in for an exemption from, for example, Section 36(b) or Section 36(a) of the statute, which imposed fiduciary duties or prohibit fraudulent conduct, you will likely find some resistance. In addition, if you asked for an exemption from Section 24(f), which requires you to pay fees to the federal government, you might have some hesitation on the part of the staff. But yet the basic authority is very broad and encompasses the entire statute. The relief has got to be necessary or appropriate in the public interest, consistent with the protection of investors and the purpose is fairly intended by the policy and provisions of the Act. I think Ken's going to talk a little bit about what that means. But those are important limitations on our authority. We don't have carte blanche from Congress to provide relief based upon any criteria we want. That's very important for a couple of reasons, one institutional and the other practical. Exemptive authority represents essentially a delegation of legislative authority from Congress to the executive branch of the government; we, the SEC, are part of the executive branch. And based upon some Supreme Court law, delegation of authority has got to be based on some criteria Congress expects the agency to follow. It simply can't delegate its constitutional legislative authority without some sort of guidance. Institutionally, it gives us a basis of saying no when we really don't want to use the authority -- very important if you are in the Division office that reviews applications for exemptions. Section 6(c) is by far the most important source of exemptive authority in

the Act and the source of authority for most of the orders and the rules we issue. Of course many of the rules and orders we issue have multiple sources of authority because after all, why choose one if you can choose multiple and give somebody seeking to sue you that much more difficult time of proving that you didn't have the authority? This is an experience we unfortunately had fairly frequently in the last few years. Sources of authority in the statute include:

- Section 17(b), a very important provision, which provides the Commission with authority to issue orders, but not rules, permitting affiliated transactions that are otherwise prohibited by Section 17(a).
- Section 6(b) -- which you might have noticed was the one listed in the announcements of this gathering today -- which provides the Commission authority to exempt employee's security companies from any provision or provisions of the Act. Now that provision is kind of interesting and different than Section 6(c) because it works together with a rule the Commission adopted -- Rule 6b-1 -- to make the exemptive orders automatically issued upon filing of the application. The Commission can come back and deny the order or can modify the order but it basically will stay in effect until the Commission acts. You have the effect of the order upon filing of the Commission and that impacts of course the criteria we use in the timeliness of our review since they need your review orders that are in effect or a little bit different from people who are actually waiting for orders.
- Section 9(c), which may not be well known to the 40 Act lawyers, is really well known to the enforcement bar here at the Commission. It permits the Commission to exempt persons from the "bad boy" provisions of the Act. Section 9(a) automatically disqualifies individuals for playing certain roles in the investment company, including being a director, investment adviser or employee who has been found to violate certain provisions of the securities laws. That means that if an adviser to a fund is involved in a settlement of a violation of the securities laws -- violations not simply under the 40 Act but the other Acts -- that settlement will typically be accompanied by an application for relief from the "bad boy" provisions in Section 9(a). The relief will typically be part of the settlement with the Commission, and it will be something that the Commission staff is required to deal with on an expedited basis in order to make the settlement work.

KENNETH BERMAN: Bob, a point about that provision. It's worth looking at because its breadth is far broader than might be intuitively obvious. For example, an affiliate of the investment advisor to a fund is found to have violated any of the "bad boy" provisions. The automatic disqualification would be triggered, so it simply doesn't involve SEC enforcement provisions; it can involve certain injunctions that come out of state court proceeding, like one brought by Eliot Spitzer.

ROBERT PLAZE: And sometimes the disqualification can come as a surprise, since it's automatic. It's important that it be acted on fairly quickly. The Division deals with those types of situations on an expedited basis in order to avoid unfortunate ramifications.

KENNETH BERMAN: In the case of Merrill Lynch it seems to have surprised the judge that issued the ex parte order, if I recall who then withdrew the order later, later on.

KATHLEEN MORIARTY: Maybe this is a little ahead of the game but isn't this an example of the kind of order that you might prioritize over most other orders?

ROBERT PLAZE: Yes. For those of you who wait for orders, sometimes it's because the staff involved in your order is trying to dig somebody out of a ditch that they dug themselves into.

KENNETH BERMAN: And just to make this process more interesting, we may touch on delegated authority later on, but the staff does not have delegated authority to issue a permanent order but does have delegated authority to a temporary order. So what will often happen is the temporary order will be issued at the time of the notice of the application so that there is basically no gap between the event that causes a disqualification and grant of the order.

ROBERT PLAZE: It's a fire drill basically when something like this happens, particularly if it's a large settlement involving multiple participants.

- Section 10(f), which gives the Commission authority to permit funds to buy securities in an affiliated sponsored underwritings.
- Finally I am just going to mention Section 2(a)(9) of the Act; it's a definitional section of the act which contains its own exemptive provision. Usually you don't think of a definitional section having such an operative effect but Section 2(a)(9) does. It defines the term "control" and is critical to determining whether a person is or is not an affiliated person for purposes of the affiliated provisions of the statute and, in doing so, creates a presumption that a non-natural person that owns more than 25% of the voting securities in a company controls the company and a person that owns 25% or less does not control the company. The SEC has the authority to determine that a person does or does not control, notwithstanding the statutory presumptions.

There are also sources of exemptive authority not within the statutory provisions but within rules themselves that the Commission has adopted. Of course, the best known provision of that is Rule 17d-1. That rule prohibits joint transactions. Section 17(d) itself doesn't prohibit joint transactions but provides the Commission the authority and that rule has been on the books since the early '40s I believe. It simply prohibits joint transactions unless the Commission shall have issued an order permitting a particular joining transaction and sets forth the criteria by which the Commission will provide an order. You are not likely to see rules like that occur in the future, adopted in the future, because it expands the Commission's workload. This type of rule was adopted in the early days when the Commission had a few hundred registrants; today, with thousands of registrants, these types of rules are less likely. In fact one exists also in the Advisers Act dealing with the "bad boy" provisions in the cash solicitation rule, and you are likely to see the staff recommend amendments to that to eliminate the requirement that the Commission get involved every time somebody has a problem.

Now one of the interesting issues is the interaction between the general exemptive authority and the more narrow grants of exemptive authority. Under canons of statutory interpretation, narrow would tend to control the specific within the statutory framework. Do narrower provisions restrict the Commission's authority under the broader provisions? This is part one of the enduring question of the Commission under the Act,

and things we will talk about as we go on. What's the scope of the Commission's authority to exempt? The interaction of the broad and narrow sources of authority is a good example. Section 17(b) of the Investment Company Act allows us to issue orders for affiliated transactions but it doesn't speak of rules. To what extent could the Commission use Section 6(c) to provide an exemption given that Section 17(b) could be construed to deny the Commission that authority? Other provisions give similar authority but give narrower criteria in Section 6(c) and raise the same questions – does the broad authority of Section 6(c) prevail over the narrower ones of other sources of exemptive authority? This was decided very early on in 1948 in a decision called *Transit Investment Corporation*, in which the Commission expressed the view that Section 6(c) gives it broad authority to grant exemptive relief and not limited by the conditions of other sections. As long as an applicant met the conditions of Section 6(c), the Commission would give orders. So now what you do have is a series of rules using Section 6(c) authority, granting of exemption to affiliated transactions that codify orders under Section 17(b), which itself does not give the Commission rulemaking authority.

Another question that has come up is whether the Commission's ability to impose conditions -- remember the Commission can grant conditional or unconditional relief -- is limited by some of the substantive provisions of the Act. I will give you an example, Section 10(a) of the Act requires funds to have boards of directors comprised of at least 40% of independent directors. Could the Commission require funds to have 75%, for example, majority -- just a random example -- as a condition for using Rule 12b-1? Well, finally after 65 years in statute in 2005 a court addressed this in the *Chamber of Commerce* decision in which it said, of course, there is nothing inconsistent with a 40% requirement by the statute imposing a 75% requirement given the fact that the statute itself suggests a concern with governance issues. So there are a couple of examples that have come up over the years that are historical in nature but really do contribute to an understanding of the nature and scope of the authority the Commission has today.

MARTIN LYBECKER: Okay, Ken, tell us about the findings that the Division must make.

KENNETH BERMAN: Well, as Bob said, let's focus on Section 6(c) initially because that's where you generally look for a source of authority. The Commission has to find that the exemption will be granted to the extent necessary or appropriate for the public interest consistent with the protection of investors and the purposes fairly intended by the policy and provisions of the act. And these standards have generally been interpreted in a very flexible fashion by the Commission and the staff. Applications are generally built around those conditions and provide the factual basis under which the Commission or the staff, under delegated authority, can make the requisite findings. Applications generally contain conditions that are designed to demonstrate that the investors in the fund will be protected. Often those conditions will appear to be procedural nature -- for example in the affiliated transaction area the orders and the rules generally will provide for review of the transaction by the fund's board.

MARTIN LYBECKER: Unfortunately, if the Division can't resolve the issues and the applicant is absolutely determined to go forward, then the Division will recommend that the Commission set down the application for a hearing before an administrative law judge. The administrative law judge is an administrative forum; administrative hearings have their own rules under the Commission's Rules of Practice. The Division is a party, and the applicant is a party, and assuming that no one else has requested a hearing, it is

just the applicant fighting with the Division in front of an administrative law judge. I submit that that's a really lousy way for the Division to effect public policy. The administrative law judges spend most of their time trying enforcement cases, not trying to figure out whether something is reasonably appropriate for exemptive relief, and having them as a matter of process be involved in what I would regard as making policy decisions traditionally has not worked out very well. One of the other problems is because the application is now before an administrative law judge in an administrative proceeding, the Commission itself has now shifted the hat it's wearing; instead of wearing its policy-making supportive hat as your boss, the Division is a party to a proceeding so the ex parte rules mean that the Division staff can't talk to the Commission at all other than on pieces of paper that you have served on the other side. I think it is very hard on the Commission to put it in the position where the Division that they want to be providing most of their policy advice is incapable of talking to them other than in writing in a formal way, and so the Commission must talk to somebody else, like the old Opinions and Review Group in the Office of the General Counsel, to figure out what the Division would have done had they had the opportunity to talk candidly. I will explain later, when we talk about some of these specific examples, how we creatively got around the ex parte rules, but it is painful to not be able to talk to your bosses about something that's important to them.

ROBERT PLAZE: Well, this process does not happen very often.

KATHLEEN MORIARTY: I was going to ask if it ever happens?

ROBERT PLAZE: Oh yes, but it's been quite a while.

MARTIN LYBECKER: Let's look at the other side. For whatever set of reasons, let's assume that Ken was able to reach all the conclusions and he was able to make the necessary findings. So, using delegated authority he or the associate director for his group has signed the order, the secretary has issued it and the consequence of receiving the order is really pretty profound for the applicant. Whatever the transaction is that is covered by the exemptive order, the applicant is now protected as against the world on that. No one has standing to say anything about its status because they weren't a party to the application and they didn't put in a request for a hearing on the application. It's really a gold seal of approval and as compared to, for example, what we all casually call no-action letters or granting no-action relief, which makes it sound like some sort of regal thing that the Division does by waving a wand, even though all the Division is doing actually is issuing a letter. With an order, there is a genuine, a definitive legal quality to it.

KENNETH BERMAN: No-action letters have a legal quality to them.

MARTIN LYBECKER: I know. But it really is substantially different in that no one can successfully challenge the issuance of an order once it has been issued. Okay, so what happens if an applicant gets an exemptive order and then its business facts change. Well, then the applicant just abandons relying on the exemptive order and, assuming that he is not otherwise violating the law, the former applicant is not violating the law. When a former applicant no longer needs to rely on the order, it doesn't have to come back to the Division and have the order revoked or expunged. For example, assume that the applicant sought and received an amortized cost order from the Commission in the early 1980s for its money market fund; by the time 1985 comes around, the Commission

has adopted Rule 2a-7, and Rule 2a-7 gives the former applicant a better deal than it got from the exemptive process, so the money market fund can rely on the rule and abandon its exemptive order. I can't think of a particular circumstance where it has happened to the Commission but it has happened to other agencies, where the applicant is not happy with the exemptive order it receives. It happened to the Board of Governors of the Federal Reserve System several times where it granted the application but the order that it issued was not what the applicant wanted. So the applicant appealed the issuance of the order. *(laughter)* I am serious; it was the order issued prohibiting the formation of non-bank banks and the applicants appealed. They appealed to a number of U.S. Circuit Courts to create a split between the Circuits, and ended up winning their case in the Supreme Court. So if the applicant does get an order that is unsatisfactory, it can appeal to a U.S. Circuit Court of Appeals.

During the next part of this program, Bob and I are going to do a sort of back and forth to try and tease out what the presence of exemptive authority means to the Division, and what effect may it have on the Division when it is thinking about using other tools, such as no-action letters.

One of the things that has always been an advantage to the Division, if it was considering a request for a no action letter that it was generally sympathetic with but the words of the statute just couldn't get you there, or you had to pretend that a foreign bank doesn't own "securities." With exemptive authority as an extra tool, the Division has always had a way, ultimately, to say "yes." The Division could take the position that it wouldn't issue a no-action letter, but be entirely sympathetic with the notion that foreign banks or foreign insurance companies should be allowed to sell commercial paper in the United States. So, the Division could say to the person requesting the no-action letter, if you file an application we will support it, and of course that's exactly what happened. The alternative, in the case of the foreign banks, would have been for the Division to have to take the position that everything the foreign bank held wasn't a "security" and that they weren't in the business of investing in securities, which would have caused the Division to have to take the position that mortgages, commercial loans, all sorts of things that were normal for a European bank were not "securities" for purposes of the Investment Company Act. That just wouldn't work.

ROBERT PLAZE: One of the tensions within the Division is what can be done by a no-action letter and what should be done by exemptive order. A no-action letter creates precedent -- we all know it's not officially precedent but it's relied on by funds and their lawyers. Any order of course is granted only to the individuals who have applied. In some cases people want relief; we might think it worthwhile but it is inconsistent with the body of no-action letters that, if we were to change, it wouldn't simply affect the transaction, it could affect a range of other transactions and how we analyze those transactions. We are more likely to push these to be exemptive requests.

KENNETH BERMAN: My only observation, and this is not intended as a criticism, but sometimes working through those issues can take a significant amount of time.

ROBERT PLAZE: Yes. Well, they are definitely difficult because you are talking first of all institutionally. You are talking about two different offices within the agency and you are talking about division directors who have changed over time and each one may have different views as to what should be done by letter or order. Finally we must tell you that

the no-action process is a lot less resource intensive than the exemptive order process and timing, and that's a consideration.

KATHLEEN MORIARTY: From the outside looking in, one of the problems I face is that often I can't tell what it is that's causing hesitancy at the staff level. For example, in addition to internal IM considerations, one aspect of an issue might involve another Division, like Corp Fin. For example, an issue might have implications under the 1933 Act as well as the '40 Act, and IM is sensitive to Corp Fin's interpretation and administration of their statute. From the applicant's or the outsider's standpoint, all of this is happening behind the screen, so it's not very often that you actually get to be involved in these discussions.

ROBERT PLAZE: It's very similar to what the IRS or the Treasury Department will go through on tax matters. You may have a perfectly good argument but what you are not aware, behind the screen, the argument you are making has some implications and some completely disconnected area of tax law and they simply can't do it.

MARTIN LYBECKER: One of the considerations, and this goes to basically how sometimes exemptive orders can become rules, is that there has been a long practice within the Division, which I personally think has been healthy and good, to try something. I don't want to call it an experiment, but the Division would use the exemptive authority to issue the first ETF order or issue the first amortized cost order, and then sit back, see what happens and use the order resources in the Commission to pay attention. That is what the Division did with the first amortized cost orders; the Division used the inspection authority of the Commission to see what the money market funds were doing, and to see if the amortized cost orders were going to work. That way, the Division gets its feet wet, the applicant can actually have an experience, and then the Division and the applicant can learn from it. Among other things, in managing the Division's workload, if it turns out that everybody wants an exemptive order to start up a money market fund, the Division can end up with hundreds of applications to do what is now codified in Rule 2a-7, and that's just an unreasonable workload for the Division. So over time, during different administrations, under different Division directors, and under different Chairmen, there has always been a focus on trying to find a pattern of applications and then turn them into a rule, which basically outsources the compliance process back to the industry and law firms. Rules 3a-5, 3a-6, 3a-7 and 3a-8 are all examples of finding a way to adopt a rule to get that line of exemptive application off the Commission's workload and allow the industry to police itself. The last thing on my list, is what I said before is true. The stamp size was different in the past, but it's a 42-cent stamp now and anybody can put it on an envelope, address the envelope to the SEC, enclose an application and it will end up on somebody's desk in the Division. People who file exemptive applications aren't necessarily asking questions that the Division would like to answer. In the early 1970s, when money market funds first began, using the amortized cost assumption in the accounting rules, we also had a Commission – all five of them – who were absolutely opposed to the idea of giving anyone exemptive relief from the requirement that marketable securities be mark to market. In that case, it was Federated Investors in Pittsburgh. They filed an exemptive application. We felt compelled to recommend to the Commission that it be set down for a hearing before an administrative law judge, and for several years, Federated and several other applicants dictated a large portion of the Division's work. We all worked on the amortized cost hearing. That was painful because we had to do all of our public policy work in front of an administrative law judge, instead of in front of the Commission.

ROBERT PLAZE: The normal process is that when an application is submitted, the staff or the Commission -- depending upon whether the staff can do it under delegate authority -- publishes a notice in the Federal Register. In the future, you are more likely going to be reading notice on the SEC website. Interested parties have an opportunity to request a hearing -- which means a hearing before the Commission -- to oppose the application or the terms under which the staff proposes to recommend the Commission issue an exemptive order. There are an interesting set of procedures for consideration of applications and, of course, in Marty's lingo any idiot with a 42 cent stamp can try to stop an exemptive order from being issued. In fact, we have had people over the years to file troublesome requests and under SEC rules -- now it's not part of the statute -- we can limit the ability of a person to force a hearing to a person who is an "interested person" and who can raise certain material facts for the Commission. Now the interested person requirement is one I am particularly interested. It's designed to protect the Commission's processes. It is designed to prevent the Commission considering a hearing request that is actually an attempt to fight another battle and to assure ourselves that the people who are contesting the application have a legitimate interest in the hearing. The Commission has stated that an interested person in its application must state an ownership or other direct interest in the funds or demonstrate that it is likely to be harmed by the granting of an application. This is the equivalent of a standing requirement in Federal court. We want to protect our processes. I think the best example of this one is the dispute between Standard & Poor's and Vanguard a few years ago. Vanguard had an exemptive application before the staff requesting an amendment to an old order in order to establish an ETF, which was going to be a series of an open end fund. Vanguard was embroiled in a dispute at that time with McGraw Hill, owner of S&P, over the right to use the S&P name for the ETF, and various matters associated with that license. It sought to intervene in the ETF applications by claiming that it would be against public interest if we were to issue the exemptive order, because the licenses were being breached by Vanguard. The staff, after seeking guidance from the Commission, denied their request for hearing relief because we thought that essentially the questions that were going to be argued in front of the Commission were essentially questions of intellectual property law, not the underlying 40 Act issues presented by the application. A similar one was the Chemical Bank merger with Chase Manhattan Bank. Matthew Lee was a local activist in New York who was interested in community lending and sought to intervene in an application for an exemptive order under Section 26, the need for which arose out of the merger, for a UIT sponsored by one of the banks. He claimed his organization was an interested person because its members may have checking accounts at these banks or may invest in unit investment trusts. The staff denied his hearing request and in doing so, developed a precedent for applying the "interested person" requirement to membership organizations that look very like the standing requirements that the DC Circuit uses to screen out participants in appeals. So when we do get hearing requests, we are very much interested in making sure that there is a serious hearing request with serious issues at stake and the Commission has the ability to deny hearing requests for those that we believe aren't.

KATHLEEN MORIARTY: I was involved in one also with an ETF. Fund Democracy sought to intervene and request a hearing on the first iShares order. What happened in that case was that Mercer ultimately withdrew his hearing request so the staff never had to address the question of whether he had standing or not. His withdrawal was based on iShares' willingness to expand certain disclosures in the prospectus, which is what he was after anyway.

ROBERT PLAZE: Very and now we were codifying the ETF orders. We have this settlement that has become a standard part of the exemptive order, but which we weren't in the development of at all and now the question that is back with the staff is do we incorporate those terms of that settlement into the rule?

KENNETH BERMAN: One point I would just like to make with in connection with dealing with persons requesting a hearing. As Bob said, the SEC staff doesn't have delegated authority to deny a hearing. The staff will be required to send an action memo to the Commission, which necessarily adds time to the process. But the other point is that, particularly in the bank merger situation, the SEC staff and the Commission have proven able to turn around an application and give it expedited treatment if there are real time constraints around issuing the order. In the Chase situation, you had a merger that I think was scheduled to close the week following the filing of the intervention. There have been other situations where there were real time constraints on transactions that have nothing to do with the Investment Company Act but for some reason an exemptive order will be necessary to deal with one aspect of the transaction. The staff has generally been extremely responsive to giving those expedited treatment – triaging – so that the order will be issued in time for business objectives to be met.

MARTIN LYBECKER: My interested person story involves representing Stanford University and requesting a hearing on the application filed by TIAA-CREF, which was seeking an exemption from the redemption requirements, during the summer of 1987. Obviously Stanford University didn't own a single one of the variable annuity contracts that TIAA-CREF had issued; they were all held for professors and employees of Stanford University. We argued for standing for Stanford University because it was the employer sending money to TIAA-CREF on behalf of its employees, and we objected to the fact that, at that time, TIAA-CREF was unwilling to honor a redemption request while every other issuer of variable annuity contracts, to which Stanford University paid money on behalf of its employees, did. There was a hearing before an administrative law judge and at one point, if memory serves, there were over 20 interveners seeking to participate in that hearing. So those of us who had real institutional clients attempted to organize our side of the hearing, and ultimately whittled down the oral arguments to one long day.

I was also named as defendant in a lawsuit brought by an intervener whose request for a hearing we recommended that the Commission turn down. There was a person in New York City who routinely filed a request for a hearing as a kind of protest with respect to any exemptive application sought by IDS and Allegheny. Throughout the late 1960s and early 1970s, he regularly asked for hearings, regardless of the merits of what IDS or Allegheny were seeking an exemptive order to do. So the law firm that was representing IDS called me the day that we would have issued the order by delegated authority and said, "You are going to get a request for a hearing; we have just gotten it here in New York." I raced around to make certain that the secretary didn't issue it. The last thing one would want to do, when you have got a request for a hearing coming in the mail, is to issue the exemptive order before we searched through the Commission's mail. We waited a few days, and it finally showed up, sure as hell, in snail mail, so there was no way we would have gotten it in time. The law firm was kind enough to send me a series of cases in which the requestor had appeared in the New York State Courts. The highest court in New York State decided that he was the kind of pernicious plaintiff that should never be allowed to file a complaint anywhere, and had referred him to the New York State Bar Association and asked for them to disbar him, but he had continued to

appear pro se. When the Commission finally got through denying his request for a hearing, he then sued IDS, the SEC and me, an unindicted co-conspirator, as it were, for violating his First Amendment rights. For a while, I was actually represented by a very lovely New York City lawyer who is famous for representing people in First Amendment cases.

The last thing on the list is venue, and of course, the example is Vanguard. As many of you know, the Vanguard Group of mutual funds is very unique in that the various funds all own their own administrator, so of course, the Division had to process a Rule 17d-1 application from them in the early 1970s to allow them to do that. Indeed, most of the 1970s were spent processing that application; it went to at least two hearings. Arthur Brown, who served as the Division's lawyer in that administrative proceeding, actually lived for several months in Philadelphia and the administrative law judge did too, and boy, did we learn from that. The venue for administrative hearings is now determined in the SEC Rules of Practice so that the venue for all hearings, absent any other consideration, is here in Washington, D.C., so that at least the Division's employees can all sleep at home and the Division's travel budget won't have to be spent on things like that.

We are down to the last part of my outline, so this is "war story" time. We have divided up the examples of situations where the exemptive application was important and the exemptive orders later morphed into something else. Kathleen, why don't you start with ETFs.

KATHLEEN MORIARTY: Well, the ETF exemptive orders haven't become "something else" yet but we are in the process of the rule making procedure that Bob was talking about earlier. The first ETF order was granted in 1993 and the rule proposal to codify the ETF applications and orders was proposed in March of this year; comments to the proposal are still coming in, I believe. So the next phase of the procedure is that Bob and his team will be looking at the comments and whatever else they feel the need to look at. Then either the final rule will be published in the adopting release or it will be modified or rewritten in another proposing release, and the cycle starts anew until a final rule is adopted or abandoned. Bob, I don't know whether you want to comment as you are in the middle of the process.

ROBERT PLAZE: For those of you in the audience who are watching I read the comments and I think they are highest qualities of comments that I have ever read on rulemaking and they are going to be very useful to us in moving forward.

KATHLEEN MORIARTY: I have been asking everybody in the industry to weigh in on the proposed ETF rule because this is their opportunity to do so. I should point out that I am the only one on the panel who has never worked on staff, so I am an "outsider." I have worked with the IM staff a very long time and from my perspective anyway, have enjoyed a wonderful relationship. In fact, several years ago, I was made to realize that I am sort of "spoiled" in this regard, when I was having a battle with someone in Corp Fin. We were going back and forth about an important topic for several weeks, when finally the Corp Fin person said, "Well, you know you are just spoiled because the IM people actually have to think about these things and make a determination because they have exemptive authority under the Act. We don't have any exemptive authority under our statute, but we can just say no." That's exactly what they did. I understood then that the discussion we are having today, about whether something should be submitted as an

application for an exemptive order or a request for no-action relief, is analyzed by IM on a regulatory as well as an interpretive basis. On several occasions, I have convinced myself that the only way to deal with an issue or a problem is to apply for an order. In discussions with IM, somebody may say, "Let's think about no-action instead, and let's kick it around; maybe we can solve the problem this way." Sometimes it works, sometimes it doesn't, but the IM staff has a flexibility of approach when trying to help an applicant get the relief they need if it's a legitimate request. In my experience, this flexibility is deeply imbedded in the staff's approach to issues and problems, and often results in creative solutions. This certainly was the case in the ETF situation, I am sure much like what Marty went through. An ETF is a creative completely at odds with the 1940 Act because it's basically a hybrid of an open-end fund and a closed-end fund.

Actually, the history of the ETF structure is very interesting. It all started because the AMEX wanted to develop new trading products that they could list. Nate Most, the head of the AMEX new products committee at the time, thought it might be a good idea to list mutual funds that could be traded on the exchange. So he went to John Bogle at Vanguard and discussed listing some of their mutual funds. John Bogle had a bunch of issues with the concept, including the fact that he felt that people frequently buying and selling on the AMEX would disrupt their whole fund portfolio management. So, Nate went back to the drawing board. He began to think about a structure, more like a custodial receipt or a basket trade, where stocks would be deposited into a fund and the fund's individual shares would be traded on an exchange at market prices. Meanwhile, institutional owners of the fund could redeem or purchase fund shares in huge lots at NAV using the underlying securities rather than by paying in cash. So this really turned out to be a hybrid structure. I was not involved in the very first presentation to IM but I think it was made in 1989. The idea and the structure progressed and worked its way through IM, Corp Fin, Market Reg and ultimately to the Commissioners, during which time lots and lots of meetings and discussions took place. The IM staff in particular was very encouraging. Finally, the SPDR Trust was granted its relief in January 1993. Note that the SPDR Trust order contained no future relief; given that the SPDR Trust was a novel product, the Commission wanted to see how it operated and was traded and received by the marketplace. The subsequent orders granted to MidCap SPDRS, DIAMONDS, WEBS and CountryBaskets again were specific to each particular product; none provided for future relief. It wasn't until the iShares Trust received its exemptions in 2001 that the Commission first granted future relief. Since that time, there are now in excess of 600 ETFs trading in the United States. They hold a wide array of portfolio investments, including domestic and foreign equity and debt securities, track broad or narrow market indexes, concentrate in particular market segments or sectors of geographic regions, follow "value" or "growth" styles, provide leveraged exposure to financial indexes or follow other specialized strategies.

The most interesting ETF project, in the Chinese sense of the word "interesting," was the ProShares order, which took seven years from start to finish. The relief requested involved not only regular ETFs but also included leveraged, inverse and inverse leveraged funds. A great deal of that time was taken up in the interface between IM and Market Reg, because Market Reg had a whole host of issues about listing products whose portfolios would include derivatives, leveraged and short positions. Their concerns were originally raised in connection with the ProShares' listing rules proposed by the AMEX, but these concerns frequently intersected with issues raised in the application for '40 Act relief. So for a long time there were joint conferences with staff members from Market Reg and IM, during which each group analyzed each issue from

vantage points driven by different statutes and public policy considerations. We were trying to please both sides of the table, which finally, finally came to fruition. I'd point out that so far there have been no ETFs as complicated as ProShares, and most ETF applications are processed much more quickly.

So although ETF applicants probably would hate to hear me say it, given the time consuming nature of this regulatory process, the '40 Act exemptive process has been a fascinating experience for me. Ultimately, all of the ETF applications and orders have led to the new rule proposal. I think everyone is looking forward to an ETF rule that not only covers much of what people do now, but also facilitates the development of the next generation of products by including "transparent active ETFs" in its scope. This is another example of the IM staff's forward thinking and flexibility, because transparent active ETF orders have only just started to be issued. The staff is trying to look ahead and has drafted a proposed rule that would permit a wider scope than just the "traditional ETFs," and I think that will be a great thing for all sides.

ROBERT PLAZE: This is a perfect example of the situation where, when the Division finally took up the rule-making, most of the heavy lifting had been done through the application process, and the Division and Commission had a track record to work from. The Division had examination reports; we had market data on how the ETFs trade and a lot of very good groundwork had been done. The ETF rulemaking is a good example of how the process works well. The "interval fund rule" is one in which the process perhaps did not. In the 1992 *Protecting Investors* study, the staff identified an anomaly under the statute in which there were open-end funds and there were closed-end funds and never the twain shall meet. They saw these closed-end funds were trading at persistent discounts and viewed this as a problem and concluded that we needed to develop a hybrid investment company. The staff came up with a hybrid we called an interval fund. This product was not the creation of the financial services industry, but the staff. I think you can count the number of ones that are out there on one or two hands right now that didn't come up. In contrast, that ETF is a vehicle designed by the financial services industry and made possible by the granting of exemptive orders. In my personal opinion, I speak only for myself here, the interval fund has the worst features of open-ended funds and closed-ended funds combined. In contrast, the ETF, which was created by a lot of very smart people who understand finance, is also a hybrid between open-ended funds and close-ended funds. Watching ETFs these past few years, it strikes me that they have the best characteristics of both open-ended funds and closed-ended funds from the perspective of an investor. And it is something which without which this exemptive process by which the ideas, financial ideas and thoughts, the creativity of the private sector can come in and we can adapt a statute consistent with the values of that statute to meet the investment needs and statute's requirements. You can see how much more successful we have been when we used that model, when we tried to use a different model in terms of come up with a solution to the problem ourselves. I think that government doesn't do certain things well, and it requires a bit of humility to understand that.

KENNETH BERMAN: One area we really haven't touched on, an area I actually find among the most interesting, is the way in which the Division deals with status questions - the existential question of whether a company is or isn't an investment company. Those types of issues come up in a number of different ways. As Marty alluded to earlier, for example, U.S. banks, U.S. insurance companies which, based on their asset composition, almost certainly would be investment companies, are specifically excepted

in the definition by the statute. The statute does not except foreign banks or foreign insurance companies. So the Division staff, initially through a series of orders, gradually got comfortable with letting foreign banks issue commercial paper and other debt instruments without registering them as investment companies. The Commission ultimately adopted a definitional rule that excepted foreign banks and foreign insurance companies that met certain conditions from regulation under the Act. The way that evolved is actually very interesting. Initially the Division proceeded under Section 6(c) which basically allows the Commission to give exemptions to investment companies or other people. That approach didn't really address the fundamental question of whether foreign banks or foreign insurance companies were investment companies. The rule that was ultimately adopted -- and the rule that's in place now, because the rule actually evolved over time -- basically said they are not investment companies and that has a number of important implications for dealing with other issues.

There is a provision in the statute, Section 3(b)(2), that basically provides the Commission with the authority to declare that certain companies which, based on an asset composition test that was adopted in 1940, fall within the definition of investment company, are not investment companies based on their primary business. The primary business test in turn was developed in a Commission decision known as *Tonopah Mining*. There actually is a Tonopah, Nevada where 40 Act lawyers, if they're driving across the Southwest, will stop and have their picture taken.

MARTIN LYBECKER: We have an associate who has lived in Tonopah and he has bought shares in the Tonopah Mining Company. He has them on his wall. It is a wonderful reminder of the *Tonopah Mining* case.

KATHLEEN MORIARTY: I gave some to a '40 Act lawyer as a present one day.

KENNETH BERMAN: The *Tonopah Mining* standard basically looks at five factors, including what had generally, and I think generally probably continues to be thought of the two most important: the composition of the issuer's assets and the sources of the issuer's income. There was recently a Seventh Circuit decision, I guess a year ago, written by Judge Easterbrook, where basically he applied the *Tonopah Mining* factors to a manufacturing company, National Presto, which is interesting reading because he seemed to suggest that the last two factors aren't actually the most important factors. I don't know if this decision has had any impact on the way the Division staff has evaluated the applications. What will happen is the company that is an investment company under this asset composition test will come in and, in its application, will explain its business and explain why it is not an investment company. Based on the *Tonopah Mining* factors the staff will, on the right set of facts, declare that they're not.

These are interesting applications because they kind of give the Division bleacher seats, if you will, on what might be happening in the economy outside of the investment management business. Among the more interesting series of applications I worked on, in 1999 or 2000, came in as the Internet boom was taking off. There were a number of companies that characterized themselves as Internet incubator companies that for a number of reasons didn't fall into a Rule 3a-1, the rule which had codified the Commission's various exemptive orders under Section 3(b)(2). They basically had to come in and, in a couple of cases did, demonstrate that notwithstanding the fact that they had some investment income issues, that they were not investment companies and they received orders. These can be very interesting orders in the sense that it gives the

Division some sense of what's going on in, for example, the Internet incubator industry and the telecommunications industry. If you go back to the 1940's it would have been the mining industry.

MARTIN LYBECKER: It's fun to work in this area. As a practitioner, your choice is always whether you feel compelled to recommend that the issuer file a Section 3(b)(2) application or, based on what Judge Easterbrook has said in the *National Presto* decision and what the litigated cases say, whether you can write an opinion under Section 3(b)(1) that will be commercially acceptable. In this area, it is very hard to write "flat" opinions. We end up writing something we would call "discursive" and "reasoned." When you end up having written 25 pages, explaining why the issuer isn't an investment company, counsel representing the underwriter often objects, making that kind of opinion essentially commercially unacceptable.

Going back to something that we talked about earlier, I'm also unfortunately the first person who filed an application on behalf of Series D Preferred Shareholders of Idealab, the Internet "incubator" company to which the Division issued an order under Section 3(b)(2) seeking to revoke the order that had been issued because I alleged that the application had been based on a false representation of the facts. The Series D Preferred Shareholders ultimately settled their civil litigation against Idealab, and then the application was withdrawn. The Division never had to decide whether to set an application filed by an applicant's shareholders down for a hearing.

KENNETH BERMAN: The other area where this comes up, which is also important to practitioners outside of the 40 Act, are a number of different types of corporate financing vehicles that again definitionally, at least in the Commission's view, appear to be investment companies. For example, financing subsidiaries that corporations set up to issue debt or preferred stock and that then on-loan the proceeds from these financings to the various affiliated companies. Are they, or are they not investment companies? It usually depends on your view as to whether inter-company debt would be viewed as a security for this purpose. Rule 3a-5, an exemptive rule, is premised on a conclusion that it would be, so if you're involved in that type of financing, you need to become familiar with Rule 3a-5.

Similarly, Rule 3a-7 is a rule that allows lots of securitization and asset backed securities to proceed without being regulated as investment companies. That rule was developed in an exhaustive process which included, I think, probably the longest chapter of the 1992 study, followed by a rule proposal. This is a rule that has permitted credit card securitizations, for example, to proceed without having to deal with the Investment Company Act. The primary impact of these rules isn't necessarily on the investment company industry. It really illustrates how the 1940 Act can have an impact on operating companies.

MARTIN LYBECKER: So, if this was the first day of class for my seminar on financial services law at Duke Law School, what I would say to you is: you need to pay attention because no matter what kind of corporate lawyer you turn out to be when you grow up, every single transaction you touch, every commercial loan, every IPO, every securitization, virtually every transaction is going to have in it somewhere a representation and warranty that says, "This issuer is not now and is not required to be registered under the Investment Company Act." This is because of Section 47(b) of the Investment Company Act. Congress changed it in 1980 to follow the ALI Federal

Securities Code model for inserting voidability instead of voidness. So Section 47(b) says that any transaction or a contract done in violation of the Investment Company Act is voidable. When you explain to commercial people, that means, that if the issuer doesn't actually know what it is and it completes a public offering while it is an illegally unregistered investment company and somebody sues, the issuer has to give all the proceeds back in a rescission offer. Under those circumstances, counsel for lenders and underwriters quite reasonably insist on getting a very clear answer to the question of whether the issuer is an investment company. So I tell my students that, if you will just pay attention to this investment company status question, you'll be employed forever.

KATHLEEN MORIARTY: One thing that's probably obvious and that we haven't mentioned is that in addition to the Act being dynamic because of the order process, all of our clients' businesses are dynamic. So, they often forget if they're operating pursuant to an order, that they have to keep thinking about the order as they progress to make sure that whatever it is that they're doing continues to be something that is permitted by order.

ROBERT PLAZE: Right. Absolutely. Under our exam procedures, we regularly look at orders that the fund has received and see if they are complying with the terms of that order. And it is not uncommon that people have forgotten about certain orders.

MARTIN LYBECKER: The other thing that did happen to the Division, I am sorry to say, in the 1970's was to discover that some of the exemptive orders that had been issued previously giving issuers status exemptions had conditions in them that had to be met and they were supposed to report back to the Division. The Division was expected to pay attention too, and of course we failed to do it.

So I think by the early 1980's, the Division had stopped putting anything with a condition subsequent in an exemptive order. If the Division issued an order, the recipient of the order went away forever. The Division did not want a responsibility whatsoever for the issuer because it didn't do a very good job of keeping track of issuers to which the Division had given partial relief.

ROBERT PLAZE: That's an issue because the staff doesn't have the authority to examine people who have an order deeming them *not* to the investment companies. So, we required these passive reports; we had to stop. I mean, in some respects this exemptive process was established and a lot of the orders and requirements and reports for much smaller industry than we have today and that's a fact of it.

I'd like to move on to perhaps the last topic we have today which I think is one of my favorite ones. It has a rich and colorful history. Ken spoke to it briefly, but I'd like to talk to you about it more specifically which is the fund-to-funds provisions. It shows that these exemptive orders and the service of exemptive orders not only leads the rules, but sometimes they actually lead to statutory changes and this is one that has been.

Now, Section 12(d)(1) prohibits fund-to-funds and it's designed to prevent pyramiding arrangements by which one financier for example can use an investment company to buy shares of another company and acquire control of their investment companies. And through use of fairly small amount of money control a pyramid of investment companies, a large amount of assets which that control can be then used for a number of nefarious things, including for example looting the investment companies. And so this was an

original part of the 1940 Act, and was tightened considerably in 1970 in response to the exploits of Bernie Cornfeld in his fund-to-funds exploits.

MARTIN LYBECKER: Okay, I can't resist. By 1972 or 1973, they'd finally published a book about Bernie Cornfeld. What he had created was the fund through which he controlled other funds, and then he paid himself as the underwriter of the top fund a sales load for the privilege of having invested in the other fund as well as, of course, having dual levels of fees between the top fund and the underlying fund. His sales mantra was "Do You Sincerely Want To Be Rich?" That's what he was telling the salesmen to get them to sell his fund of funds.

And there was a period of time in the 1970's and 1980's where the Division would get visits from people coming from the Philippines or from South America where Bernie Cornfeld's operation had been especially abusive. If we were meeting with the Ministry of Finance, we'd always be saying, "Where's your mutual fund industry? Where's the people's savings going to be invested?"

"No-no-no. Bernie Cornfeld came here. No mutual funds. No mutual funds. No mutual funds." In the end, of course, Bernie Cornfeld died.

KENNETH BERMAN: That was Robert Vesco, who was recently reported to have passed away?

MARTIN LYBECKER: Bernie Cornfeld died awhile ago, too, and the obits were classic. The New York Times obit – Bernie Cornfeld, famous financier lives in Switzerland, then it described the last nit-wit scheme he had that was supposed to raise money. And only then does the obit refer to all of the beautiful women who shared his Swiss chalet at one time or another. The Washington Post handled it exactly the other way. The first thing it discusses is Heidi Fleiss, the last woman who lived with him and she is famous as the "Hollywood Madam." It was just classic New York Times versus Washington Post.

ROBERT PLAZE: I told you this was a story with rich history. And I am sure that many people have been drawn to the 40 Act law just in order to deal with these issues, but back to business for a moment. The section limits the amount of shares of one fund that another fund can buy. It basically says a fund can't invest more than 3% of its asset shares in any of the other funds and any more than 5% of its assets in any other fund. And it limits it overall basket to 10%, no more than 10% of your shares in other funds.

Now, the first orders we issued was in 1982 to allow cash sweeps. This was, I believe, Frank Russell Company. A fund having a cash sweep arrangement takes its cash and, instead of managing it itself, invests it in a money market fund. It's more efficient. The conditions of those orders provided a very limited exemption to exceed the Section 12(d) limits. And then in 1983, Vanguard approached the staff and wanted an order that would simply wipe out, I guess from the staff view, the whole of Section 12(d). It wanted to set up a scheme by which a Vanguard fund would invest exclusively in other Vanguard funds.

It wouldn't just violate one of the limitations in Section 12(d), but all of them simultaneously! But Vanguard's argument was that investors would benefit this because they would be getting asset allocation services for this. The top level fund was not going to be charging duplicate fees, but would be paying an additional level of Rule 24f-2 fees.

But the Vanguard application raised fundamental issues in terms of how we approached Section 6(c) and the breadth of authority to grant an exemption based on notions of public policy and how that interacted with the provision of Section 6(c) dealing with the policies and purposes of the statute. How you defined a policy and purpose of this statute? And since Congress had revisited this area just a few years hence, ought the Commission to be doing wholesale violence, some thought, to the statute. There was a debate within the staff, and you could see that debate ultimately within the Commission, for it was a three-two vote that it was ultimately approved with the dissent that Ken discussed.

In 1989, a few years later, the Commission unanimously gave similar relief to T. Rowe Price, although we did extract a couple of more conditions at the time. 1996 is where things got really interesting. There was a conference, remember Ken? A mutual funds conference where a leading member of Congress -- I believe at that time the Chairman of the sub-committee on securities -- announced that he was going to do mutual fund legislation, and he wanted fund-of-funds reform.

MARTIN LYBECKER: It was the one thing that Rep. Jack Fields (R., Texas) identified that was broken. Broken, absolutely needed to be fixed.

ROBERT PLAZE: And since we'd given Vanguard and T. Rowe Price the relief they wanted, and since nobody else was asking for the relief and we had no applications pending, Ken and I together with Barry Barbash, who was Director at the time, sat around his office the Monday morning after reading about the speech, wondering exactly what did Congressman Fields have in mind.

I'm not sure Congressman Fields had anything particular in mind as far as we could tell, but we hatched our idea about that time. Why don't we draft some legislation that would codify Vanguard and the T. Rowe Price orders? Ken, I believe you did that.

KENNETH BERMAN: We drafted language that codified these orders. In recognition that these products were likely to develop beyond those orders and in an effort to save the Commission from a debate similar to what they had in connection with the Vanguard application, we inserted an additional exemptive provision into 12(d)(1) that basically focuses on the interest of investors. We omitted the provision relating to the policies and provisions of the Act on the theory that that omission coupled with some legislative history that said we should use the authority in a progressive way would avoid debates over authority.

MARTIN LYBECKER: Yes, and that demonstrates how, if you can't persuade Congress to change the words in the statute, you always talk to the House Committee's legislative staff and help them write the legislative history. And that's why the Commission was told to administer it "in a progressive way." I wrote those words on my word processor.

ROBERT PLAZE: As a result of this, the amendments to Section 12(d)(1) and the legislative history that accompanied it, we have now issued more exemptive orders in this area, and we have also done a considerable amount of rulemaking in the last couple of years.

First of all was the codification of Vanguard orders which meant that of these internal fund-to-funds within the same complex could be done without seeking individual exemptive orders. So that eliminated the need to do some orders as these things increased.

But also the Commission went further, relying on the legislative history, to grant relief to affiliated fund-to-funds under certain circumstances. Charles Schwab, I believe, got the first order.

MARTIN LYBECKER: Unaffiliated...

ROBERT PLAZE: Right, unaffiliated fund-to-funds, on terms that would prevent the problems with Bernie Cornfield. The innovation designed to address the Cornfield problem, Ken, which I think you developed at your time here at the Commission, was that there would be an agreement between the investing and the investee fund which would allow the fund to prevent itself to control the amount of investment coming into the fund and how they redeem their interests in the fund.

MARTIN LYBECKER: Lest you now think that everything in the Investment Company Act was thoughtfully drafted and done well, the provisions are clear as a bell, and the public policy is impeccable, Section 12 is the very best example of what Metternich or Bismarck said: with sausages and legislation, you should just appreciate the result and not focus too hard on how it came into being.

My personal favorite is Section 12(d)(1)(F). Representative Claude Pepper had a constituent in his district named Milton Mound. Milton Mound had an ugly little fund-to-funds business where he charged a 1 ½ % load, but he promised not to own more than 3% of anybody else's fund. I've always understood that he begged Claude Pepper to make sure that he could continue to sell his fund of fund product in Florida.

Section 12(d)(1)(F) was added to the Investment Company Act in 1970, and is still there with none of the investor protections, that Bob just talked about, to protect against the double feeing or conflict of interest considerations or anything else. That kind of fund of funds is limited in its sales load and can't own more than 3% of another fund, but those are not serious investor protections by any means. So, there are weird things in the Investment Company Act also.

ROBERT PLAZE: Anyway, we have recently in the last couple of years used this authority to codify the cash sweep orders -- if you remember, the first one given in 1982 - - and we've recently proposed, Kathy along with the ETF rules, a rule allowing funds to invest in ETF's on a basis much more relaxed, much more liberal than the Schwab orders would allow and would permit them to do that without seeking relief from the Commission.

It's very common for mutual funds these days to use ETFs to seek exposure or to hedge positions using ETF. They never thought of it as, they hardly think of them as investment companies. They're traded on a secondary market. And recently a sweep ICIE discovered that there was a common violation. People simply didn't think of ETFs as investment companies. They were bought on exchange, codified that -- proposed to codify that relief and that's pending currently.

MARTIN LYBECKER: Well, we've come to the end of the line. Thank you all for being here in person. Kathleen, Bob and Ken, thank you very much for participating in this. I hope we've proved both the first and the secondary premises that the exemptive authority in the Investment Company Act is unique and that it has certainly affected the Division of Investment Management's administration of the Act as well as become a unique part of the Commission's own history. For the audience both here and listening online at www.sechistorical.org, this program is now permanently preserved in the virtual museum and archive in audio format. You can listen to our discussion again at anytime. The podcast version will be available next month and a transcript of our discussion will be in the museum later this year. I would like to invite all here in the auditorium and within the SEC building to join us now in the foyer for the ice-cream social to celebrate the 74th birthday of the U.S. Securities Exchange Commission. Thank you for being here today.