MEMORANDUM

TO: Russell B. Stevenson, Jr., Deputy General Counsel
Office of the General Counsel

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

Kathryn B. McGrath

RE: Amendments to the Investment Company Act of 1940

DATE: August 8, 1983

Attached are summary responses concerning possible amendments to the Investment Company Act of 1940, which the Division of Investment Management has prepared at the request of Richard Breeden, Deputy Counsel to the Vice President and Executive Director of the Vice President's Task Group on Financial Services. Please note that our recommendations are preliminary, since we have just commenced a detailed review of the Investment Company Act. Also, although we have discussed these recommendations in general terms with Chairman Shad and Commissioner Treadway, they have not been reviewed or approved by the Commission or circulated for comment to other Commissioners or members of the staff.

In the Division's view, the proposed amendments would eliminate certain unnecessary regulatory burdens that ultimately are borne by investment company shareholders, without diminishing shareholder protections. These statutory changes also would complement the rulemaking and other administrative actions that are being taken by the Securities and Exchange Commission to streamline and simplify the regulation of investment companies, and would help set the stage for harmonizing the regulation of all financial institutions according to the functions they perform.

1. Amend Section 40(a) of the Investment Company Act of 1940 to permit the Securities and Exchange Commission to grant exemptions from the Act without a lengthy notice and comment period.

Explanation: Persons subject to the Investment Company Act frequently apply to the SEC for exemptive orders permitting transactions otherwise prohibited by the Act. In all such cases, Section 40(a) of the Act requires *Federal Register* publication of notice of the application before the SEC may grant or deny the requested relief. This notice requirement is intended to provide investment company shareholders and other interested persons, including competitors, an opportunity to voice objections and to request a hearing on the application. However, many, if not most, applications are non-controversial and amply precedented, and the publication of notice seldom elicits any response. Nevertheless, as a result of the notice requirement, final SEC action on an application is delayed 30 days beyond the period needed. This delay adversely affects the applicant, who must await final SEC action before going forward with the transaction in question. Preparation and publication of the notice also unnecessarily adds to the cost and paperwork burden of the application process. Accordingly, the Division of Investment Management concurs in the recommendation that Section 40(a) be amended to permit the SEC, in its discretion, to provide a notice period only for applications involving novel or unique issues, or upon request of the applicant. In lieu of the mandatory *Federal Register* notice period, a brief announcement of the filing of the application should be provided in the *SEC News Digest*. The application would, of course, continue to be made available for public inspection or copying at the SEC, and the SEC's final order disposing of the application would be published in both the *Federal Register* and the *SEC Docket*. This procedure would ensure that the public is made aware of all applications and, at the same time, would avoid the delays inherent in the present system.

2. Amend Section 36(b) of the Investment Company Act of 1940 to clarify the fiduciary standards applicable to advisory fees.

Explanation: Investment company directors, at least 40 percent of whom must be independent or "disinterested," are charged with a number of specific responsibilities under the Investment Company Act, including annual consideration of whether to approve the company's contract with its investment adviser. The investor protection afforded by this independent director review of investment advisory fees was supplemented in 1970 with the addition of Section 36(b) to the Act. Section 36(b) imposes on an investment adviser to a registered investment company a fiduciary duty with respect to the compensation received for the adviser's services, and authorizes shareholders to sue for alleged breaches of this duty. Unfortunately, Section 36(b) does not provide objective standards or any other guidance to investment company directors, investment advisers, or the courts as to what constitutes compliance with this fiduciary duty. Since Section 36(b) was added to the Act in 1970, numerous shareholder derivative suits have been filed challenging investment advisory fees. The time and money spent on these suits has been considerable, and many companies have settled simply to avoid the burdens of protracted legal proceedings. In addition, even advisers and funds that have not been sued have devoted substantial resources to efforts to comply with Section 36(b), both because of the fear of suits and because the section does not provide clear standards. These costs do not appear justified by the incremental benefits afforded by Section 36(b) to shareholders. Although the settlement of certain cases has resulted in some reduction of advisory fees, the extent to which investors actually have benefited from these cases is questionable, particularly in light of the litigation and other costs they must bear directly or indirectly. Moreover, most of the challenged fees have been in line with industry norms. To provide guidance in this area and avoid unnecessary litigation, the Division of Investment Management concurs in the recommendation that Section 36(b) be amended to provide objective standards by which advisory fees may be evaluated.

3. <u>Amend Sections 2(a)(3) and 17 of the Investment Company Act of 1940 to simplify and reduce the scope of the prohibitions against transactions involving investment companies and their related persons.</u>

<u>Explanation</u>: Section 17 of the Investment Company Act and the rules thereunder prohibit a broad range of transactions involving investment companies and their affiliated persons, as defined in Section 2(a)(3) of the Act, unless the SEC has provided a specific exemption by rule, or gives its prior approval to the transaction pursuant to an application. These prohibitions provide important investor protections in situations that involve potential conflicts of interest, but they also encompass many business transactions where the investment company is in no danger of being overreached. Additionally, the extremely broad definition of affiliated person in Section 2(a)(3) of the Act brings within the prohibitions of Section 17 many persons with only remote connections with an investment company. The SEC's rules under Section 17 provide automatic exemptions for certain classes of transactions otherwise prohibited by the statute, and the SEC has granted numerous applications for relief from Section 17. However, the SEC's rules under Section 17 are complex, and the application process is expensive and time-consuming. Moreover, the SEC's experience with these exemptive rules and applications demonstrates that Section 17 and the accompanying definitions can be simplified and narrowed without sacrificing investor protection. Therefore, the Division of Investment Management agrees that the scope of Section 17 can and should be limited to only those situations where there is a legitimate need to protect an investment company from real conflicts of interest and where less burdensome means of regulation, such as disclosure, are not sufficient. By contrast, customary business transactions approved by fund directors and not involving potential for abuse or overreaching should be exempted from the scope of Section 17, although the current disclosure requirements would continue to apply. Existing exemptions from Section 17 which the SEC has adopted administratively, by rule or order, should be codified.

4. <u>Amend Section 7(d) of the Investment Company Act of 1940 to eliminate certain barriers to registration by foreign investment companies under the Act.</u>

Section 7(d) prohibits a foreign investment company from registering with the SEC as an investment company and offering its shares in this country, unless the SEC finds that, by special circumstances or arrangements, it is both legally and practically feasible to enforce the provisions of the Act against the company and that it is otherwise consistent with the public interest and the protection of investors to permit the offering. In some cases, foreign investment companies (Canadian companies, for instance) have been able to satisfy this standard by operating in compliance with the Act and making adequate provision for judicial enforcement of the Act, both in the United States and their countries of origin. However, in other cases, Section 7(d) has served as a barrier to foreign investment companies which cannot satisfy the standards of Section 7(d) because of conflicting laws of their own countries. In such cases, it may nevertheless be appropriate to permit a foreign investment company to offer its shares in this country, even if it is not literally possible to enforce all the provisions of the Act as to that company, provided that other arrangements can be made to protect investors satisfactorily. Accordingly, the Division of Investment Management concurs in the recommendation that Section 7(d) of the Act be amended to authorize the SEC to permit the registration of foreign investment companies in such circumstances.