



TESTIMONY OF

**ARTHUR LEVITT, CHAIRMAN
U.S. SECURITIES AND EXCHANGE COMMISSION**

**CONCERNING S. 1815, THE
"SECURITIES INVESTMENT PROMOTION ACT OF 1996"**

**BEFORE THE
COMMITTEE ON BANKING, HOUSING, AND URBAN
AFFAIRS**

UNITED STATES SENATE

JUNE 5, 1996

U. S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

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EXECUTIVE SUMMARY

The Commission welcomes the introduction of S. 1815, which adds momentum to similar securities legislation currently under consideration in the House of Representatives. Over the last decade, the U.S. securities markets have dramatically increased in size. In addition, about 160 million Americans today -- over half the population -- own stocks, either directly or through savings or retirement plans that invest in stocks. The growth and transformation of the U.S. securities markets challenge the Commission and Congress to re-think the way that we regulate.

The Commission is committed to supporting regulatory change in ways that maintain and improve the protection of investors, and facilitate the formation of capital by U.S. businesses. S. 1815 builds on initiatives that the Commission has undertaken in recent years to: (1) simplify and improve disclosure requirements; (2) promote capital formation; (3) streamline and coordinate regulatory efforts; and (4) promote the international competitiveness of the U.S. securities markets.

S. 1815 would help to modernize the securities laws through provisions that clarify the responsibilities shared by federal and state regulators, and through significant amendments to the Investment Company Act of 1940, the primary statute governing mutual funds. The Commission supports the thrust of these amendments, and recommends additional provisions and modifications that would enhance its ability to regulate the securities markets.

Allocation of Responsibility Between Federal and State Regulators. S. 1815 would more clearly define the roles of federal and state securities regulators, a goal that would have seemed revolutionary only a year ago. In doing so, the bill recognizes the key role that state regulators play in prosecuting securities fraud and educating investors. At the same time, however, the bill does not address issues -- namely, certain securities registration and broker-dealer provisions -- that the Commission believes would be helpful to address in the context of federal-state securities regulation. The Commission supports the addition of such provisions, which the attached testimony describes in greater detail.

Investment Company Act Amendments. The bill would also help to modernize the Investment Company Act, a law that has not been significantly revised for over 25 years. The Commission has previously supported many of the changes proposed in S. 1815, which include provisions on fund advertising, deceptive fund names, and investment pools for sophisticated investors. In addition, the Commission urges that Congress adopt additional amendments to the Investment Company Act to augment the Commission's authority concerning recordkeeping and inspections, in order to improve the Commission's oversight of the investment company industry.

The Commission hopes that the introduction of S. 1815 will serve to continue the dialogue that has begun on the significant issues raised by this bill and by H.R. 3005, its counterpart in the House of Representatives, and that these efforts will culminate in the passage of legislation in this Congress. The Commission stands ready to assist in these efforts and to participate in the process of crafting legislation that all may support.

SUMMARY OF COMMISSION RECOMMENDATIONS ON S. 1815

I. Title I – Investment Advisers Integrity Act

Section 102 – Funding for Enhanced Enforcement Priority. Section 102 authorizes an appropriation of \$16 million for the enforcement of the Investment Advisers Act for each of fiscal years 1997 and 1998. **The Commission opposes this provision.**

Section 103 – Improved Supervision Through State and Federal Cooperation. Section 103 calls for states to assume a primary role with respect to investment advisers that are small businesses. **The Commission supports this provision.**

Section 104 – Interstate Cooperation. Section 104 would limit state regulators to enforcing (1) books and records and (2) financial responsibility laws of the "home" state of the investment adviser to ensure uniformity. **The Commission recommends that the Committee consult with the states regarding this provision.**

Section 105 – Disqualification of Convicted Felons. Section 105 would allow the Commission to deny or withdraw the registration of any person as an investment adviser who has been convicted of a felony, and the registration of any adviser with whom such person is associated. **The Commission supports this provision.**

II. Title II – Facilitating Investment in Mutual Funds

Section 202 – Funds of Funds. Section 202 would amend the Investment Company Act to address two types of arrangements that involve investments by a registered investment company in another registered investment company. **The Commission supports this provision.**

Section 203 – Flexible Registration of Securities. Section 203 would amend the Investment Company Act to implement a new system under which mutual funds and certain other types of investment companies would pay registration fees under the Securities Act. **The Commission supports this provision, with one reservation regarding its effective date.**

Section 204 – Facilitating the Use of Current Information in Advertising. Section 204 would expressly authorize the Commission to permit investment companies to use a new type of "advertising" prospectus for purposes of the Securities Act. **The Commission supports this provision.**

Section 205 – Variable Insurance Contracts. Section 205 would amend the Investment Company Act, as it relates to the regulation of variable insurance contracts, in order to provide for different treatment between such contracts and periodic payment plans. **The Commission supports this provision.**

Section 206 – Prohibition on Deceptive Investment Company Names. Section 206 would amend the Investment Company Act to grant the Commission rulemaking authority to define investment company names, or the title of the securities they issue, as materially deceptive or misleading. **The Commission supports this provision.**

Section 207 – Excepted Investment Companies. Section 207 would amend the Investment Company Act by creating a new exception from the Act's regulation for investment funds designed for financially sophisticated "qualified" investors. **The Commission generally supports this provision, with certain reservations.**

Section 208 – Performance Fee Exemptions. Section 208 would amend the Investment Advisers Act to except investment advisory contracts with qualified purchaser pools from the Act's prohibition on performance fees, and authorize the Commission to exempt from that prohibition investment advisory contracts with sophisticated clients and clients that are not U.S. residents. **The Commission supports these provisions.**

Title III – Reducing the Cost of Saving and Investment

Section 301 – Exemption for Economic, Business, and Industrial Development Companies. Section 301 would create an exemption under the Investment Company Act for a company whose activities are limited to the promotion of economic, business, or industrial development of enterprises doing business in the state in which the company is organized. **The Commission supports this provision.**

Section 302 – Intrastate Closed-end Investment Company Exemption. Section 302 would expand the Commission's authority to exempt from Investment Company Act regulation closed-end funds that publicly offer their securities solely within a particular state, by increasing the aggregate offering amount of securities that could be offered by these companies from \$100,000 to \$10,000,000. **The Commission supports this provision.**

Sections 303-307 – Business Development Companies. Sections 303 through 307 would amend certain portions of the Investment Company Act that pertain to business development companies. These amendments would provide business development companies with more flexibility in a number of respects. **The Commission generally supports these provisions, with certain reservations.**

Section 308 – Facilitating National Securities Markets. Section 308 contains proposed amendments to the federal securities laws that would preempt in specific circumstances state requirements with respect to securities registration. **The Commission supports these securities registration preemption provisions, with one request for clarification and various technical comments.**

Section 309 – Exemptive Authority. Section 309 would amend the Securities Act and the Exchange Act to provide the Commission with a grant of general exemptive authority under those Acts. The Commission supports these provisions.

Section 310 – Analysis of Economic Effects of Regulation. Section 310 would authorize appropriations of \$6 million for each of fiscal years 1997 and 1998 for the Commission's Economic Analysis Program. It would also require the Chief Economist of the Commission to prepare a report on each rule proposed by the Commission. The Commission opposes this provision.

Section 311 – Privatization of EDGAR. Section 311 would direct the Commission to submit a report to Congress within 180 days concerning Commission plans for promoting competition and innovation of the EDGAR system through privatization of all or any part of the system. The Commission supports this provision, with minor amendments.

Section 312 – Improving Coordination of Supervision. Section 312 would require the Commission and the SROs for broker-dealers to eliminate unnecessary duplication in the examination process. The Commission supports this provision.

Section 313 – Increased Access to Foreign Business Information. Section 313 would address the status of offshore press conferences and related materials under the Securities Act and the Exchange Act. The Commission supports the purposes of these provisions, but believes they should be addressed through Commission rulemaking.

Section 314 – Short-form Registration. Section 314 would require the Commission to amend the eligibility criteria for short-form securities registration. The Commission supports the concept of allowing non-voting common stock to be included in determining short-form registration eligibility, but believes this should be addressed through Commission rulemaking.

Section 315 – Church Employee Pension Plans. Section 315 would exempt from most federal securities regulation church employee pension plans meeting the standards described in section 414(e) of the Internal Revenue Code of 1986. The Commission generally supports the exemption for church plans and their related persons, but has certain reservations.

Section 316 -- Promoting Global Preeminence of American Securities Markets. Section 316 expresses the sense of the Congress concerning the importance of establishing a comprehensive set of generally accepted international accounting standards that could be used in such offerings. The Commission agrees with the sense of Congress on this point and is prepared to submit the specified progress report.

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UNITED STATES SENATE

June 5, 1996

Chairman D'Amato and Members of the Committee:

I appreciate this opportunity to testify on behalf of the Securities and Exchange Commission ("Commission" or "SEC") regarding S. 1815, the "Securities Investment Promotion Act of 1996."

Let me begin by congratulating Chairmen D'Amato and Gramm for introducing S. 1815, as well as the other co-sponsors of the bill, Senators Dodd, Bryan and Moseley-Braun. S. 1815 contains significant provisions that would more clearly define the partnership of shared responsibilities between federal and state securities regulators. Only a year ago, these changes would have been viewed as revolutionary. The transformation of the debate is a testament to the broad, bipartisan support for dramatic legislative changes in this Congress that would benefit investors, industry and government alike. The bill would also help to modernize the 56-year old Investment Company Act, a law that has not been substantially changed since 1970, in ways that the Commission has supported in the past.

S. 1815 adds momentum to similar legislation currently under consideration in the House of Representatives. Although the Commission has endorsed H.R. 3005 and can

support many of the parallel provisions contained in S. 1815, there are a few provisions in this bill that the Commission would prefer be omitted. At the same time, S. 1815 contains additional provisions that would enhance the effectiveness of H.R. 3005 if they were added to that bill. The Commission hopes that the introduction of S. 1815 will serve to continue the important dialogue that has begun on the significant issues raised by these bills, and that these efforts will culminate in the passage of legislation in this Congress. The SEC stands ready to assist in these efforts and to participate in the process of crafting legislation that we all may support.

This statement discusses some of the more salient issues raised by S. 1815 within the context of recent developments in the securities industry and its regulation. An appendix attached to this statement analyzes the specific provisions of S. 1815 in detail and discusses the Commission's views on each of those provisions.

I. Introduction

The U.S. securities markets play a dual role in the American economy. First, securities markets provide investors a means to invest money for retirement, save money for college education and earn money by participating in the growth of U.S. and foreign businesses. Today, about 160 million Americans – over half the population – own stocks, either directly or through savings or retirement plans that invest in stocks. Second, the money provided by investors gives businesses – both small and large – access to capital that is the lifeblood of corporate operations and expansion. Today, the U.S. securities markets serve the needs of almost 13,000 public companies,¹ raising capital to support new

industries, finance operations, create jobs, fund research and development, and support growth for the future. In 1995 alone, some \$900 billion worth of securities were sold in our markets.

S. 1815 has been introduced in a period of phenomenal performance in the securities markets. Between 1980 and 1995, for example, the value of public offerings (including debt and equity, but not investment company securities) increased more than ten-fold, from \$58 billion to \$768 billion. Between 1990 and 1995, the dollar volume of equities traded on U.S. securities exchanges and NASDAQ grew 182%, with over \$5.94 trillion traded in 1995. Volume continues to explode. December 15, 1995 was the heaviest trading day in the history of the New York Stock Exchange, with over 636 million shares trading hands. Last month, the Dow Jones Industrial Average, viewed in its 100 years by many around the world as the primary barometer of the stock market, reached record highs. On NASDAQ, record daily volume was set on May 7, 1996, exceeding 806 million shares. Over the last few months, the share volume on all U.S. markets combined has generally exceeded one billion shares each day.

Dramatic growth also has occurred in the mutual fund and investment adviser sectors of the securities industry. In 1970, investors could choose from among 361 mutual funds. Today, over 5,500 mutual funds (almost twice the number of stocks trading on the New York and American Stock Exchanges) and over 500 closed-end funds are available to investors. Mutual funds, which in 1970 held approximately \$48 billion in assets, now hold over \$3 trillion in assets. Similarly, the number of investment advisers registered with the Commission has swelled to 22,500. The assets they manage have also increased: since

1980, assets managed by registered investment advisers (excluding assets of registered investment companies) have risen from \$205 billion to almost \$8 trillion, an increase of over 3,600%.

The dramatic growth and transformation of the U.S. securities markets present new challenges for regulators and Congress. Today the U.S. securities markets are widely regarded as the deepest, most liquid and fairest markets in the world. But just as the need to constantly update, revise and innovate products and services in order to remain competitive is the driving force behind American enterprise, the crucial task for federal and state regulators is to revise and re-think the way that we as regulators do business -- so that U.S. businesses may maintain their competitive edge in a changing world economy. Businesses compete best in an arena where the rules promote honesty, intelligence and hard work, and the securities markets are no exception. Accordingly, investor protection and market integrity need to be the touchstones in this important effort to effect dramatic, meaningful changes in securities regulations, an effort that S. 1815 admirably undertakes to accomplish.

II. Recent Commission Achievements and Ongoing Initiatives: Selected Highlights

The provisions of S. 1815 build on initiatives that the Commission has undertaken in the recent past. Over the past two years, the Commission has attempted to design new means to promote the efficiency and fairness of the U.S. securities markets, with minimal regulatory burden. A sampling of these initiatives includes the following:

Simplification and Improvement of Disclosure Requirements

- The SEC has worked with the investment company industry and state securities regulators to develop a "fund profile," a standardized, short-form summary of

a fund's full prospectus. The profile is designed to be more understandable to investors, and initial investor reaction has been very positive. In a related area, a similar profile program for variable annuities was announced yesterday.

- Last July, the Commission proposed improved disclosure requirements for money market funds to simplify money market fund prospectuses, making them less costly to prepare and more understandable to investors.
- In the area of derivatives, the Commission late last year proposed rule amendments that are designed to help investors assess the market risks of derivatives investments by public companies.
- The Commission is facilitating public access to corporate filings on the Commission's Electronic Data Gathering, Analysis and Retrieval ("EDGAR") system, and reevaluating and updating EDGAR to take advantage of new technology. The Commission has also approved the issuance of two interpretive releases designed to encourage issuers to use electronic media to provide prospectuses and other disclosure documents to investors, and to allow broker-dealers, investment advisers and transfer agents to deliver information to their customers and clients.

Promotion of Capital Formation

- In March 1996, an internal Commission Task Force on Disclosure Simplification released a report proposing revisions to modernize and streamline the regulatory framework that governs corporate finance and accounting. The report recommends the elimination of 81 rules and 22 forms and schedules, as well as the modification of dozens of other rules, forms and schedules, related to corporate finance. The Commission has acted on many of the proposals already and expects to take further action soon.
- The Advisory Committee on the Capital Formation and Regulatory Processes, headed by Commissioner Steven Wallman, is expected shortly to recommend further reforms of the registration and disclosure process – perhaps including a shift from a securities registration system to a company registration system.

Streamlining and Coordination of Regulatory Efforts

- The SEC has eliminated the need for prior review of certain rule filings by self-regulatory organizations ("SROs") such as the NASD and securities exchanges.

- The Commission has reallocated existing resources to establish a new Office of Compliance Inspections and Examinations to conduct and coordinate examinations of brokers, dealers, securities exchanges, investment companies and advisers, and transfer agents.
- The Commission has entered into a memorandum of understanding with state securities regulators and SROs to share information, coordinate examinations, create a computerized tracking system, and hold regular planning summits.

Promotion of the International Competitiveness of U.S. Securities Markets

- The Commission has streamlined the registration, reporting and reconciliation requirements for foreign companies.
- The SEC has permitted, in cross-border offerings, the use of certain international accounting standards in portions of financial statements filed with the Commission.
- The Commission has actively supported, through the International Organization of Securities Commissions ("IOSCO"), the efforts of the International Accounting Standards Committee to develop high quality, comprehensive international accounting standards.

These initiatives are but a sample of the Commission's efforts to reduce regulatory burdens. At the same time, the Commission is aware that as an administrative agency, it must operate within the boundaries set by the securities laws. Accordingly, it welcomes efforts, such as those contained in S. 1815, that would provide the SEC with the tools to respond more flexibly to a changing market environment. It is in this context that the Commission turns, below, to a discussion of some of the most salient issues raised by S. 1815.

III. Significant Issues Raised by S. 1815

A. Rethinking the Federal-State Regulatory Partnership

Overview. Several provisions of S. 1815 would amend the federal securities laws to preempt state requirements in the areas of investment adviser regulation and the registration of specified securities offerings, including offerings by investment companies and offerings of nationally listed securities. The bill does not, however, preempt state regulation in the broker-dealer area.

The current system of dual federal-state regulation is not the system that Congress -- or the Commission -- would create today if we were designing a new system. While securities markets today are global, issuers and securities firms still must register many securities offerings in 52 separate jurisdictions; satisfy a multitude of separate books and records requirements; and bear the substantial costs of compliance with the overlapping requirements. The current scheme of federal-state regulation is particularly onerous for investment companies, which are extensively regulated by the Commission, and whose business is fundamentally national in nature.

At the same time, however, state securities authorities play an essential role in the regulation of the U.S. securities industry. State regulators are often the front line of defense against developing problems; they are the "local cops" on the beat who can quickly detect and respond to violations of law. Further, the states have been aggressive in seeking to publicize instances of possible fraud and abuse as a means of better educating investors.

It appears that an appropriate balance can be attained in the federal-state arena that better allocates responsibilities, reduces compliance costs and facilitates capital formation,

while continuing to provide for the protection of investors. The bill's approach to the division of responsibilities in the investment adviser and investment company areas exemplifies such a balance.

Additional Amendments Suggested for S. 1815. The Commission has endorsed H.R. 3005, which would preempt state law requirements, particularly in the areas of securities registration and broker-dealer regulation, that are not preempted in S. 1815. These other provisions also achieve the goals of regulatory simplification and protecting investors. While S. 1815 takes important steps in the right direction, a combination of the approaches in S. 1815 and H.R. 3005 would provide a more comprehensive rationalization of our federal-state system.

Securities Registration. S. 1815 includes significant securities preemption provisions with respect to investment companies, and would codify existing state law exemptions for issuers whose securities are "nationally traded," that is, listed on the New York Stock Exchange, American Stock Exchange, or on the NASDAQ National Market System. However, other securities preemption provisions could be included that would enhance the utility of the securities preemption provisions without sacrificing investor protection. For example, H.R. 3005 provides relief for smaller businesses that are not "nationally traded" by preempting federally registered offerings by companies that have two years of audited financial statements and at least \$10 million in assets.

H.R. 3005 also provides helpful simplification by preempting state regulation of secondary market trading transactions, and of certain exempted securities (such as commercial paper) and municipal securities (except in the state where issued). Most of these

transactions already are exempt in the states through differing formulations; codification of the exemptions could reduce "blue sky" expenses considerably.

The Commission supports these provisions and believes it would be worthwhile for the Committee to consider each of these provisions as possible additions to S. 1815.

Broker-Dealers. S. 1815 would not preempt state involvement in broker-dealer regulation. The Commission has supported a number of limited provisions in this area contained in H.R. 3005, which are worthy of the Committee's consideration.

As a general matter, the Commission recognizes that state regulators have a compelling interest in determining who may do business within their borders, and in how such business is conducted. The Commission also recognizes, however, that businesses trying to compete in today's changing financial world are hindered by the potentially conflicting requirements of 52 jurisdictions, and that, for this reason, securities firms have a compelling interest in a centralized and predictable regulatory system.

Balancing these two concerns, the Commission believes that states should continue to license broker-dealers that do business within their respective jurisdictions, and to receive fees for licensing such broker-dealers. States already have begun to create greater uniformity by developing a central registration depository system for broker-dealer registration. The Commission also believes, however, that states should not impose books and records and capital requirements that exceed applicable SEC and SRO standards. H.R. 3005 would preempt state laws that impose books and records requirements, as well as financial responsibility and reporting requirements, that are inconsistent with or that exceed

requirements established under the Exchange Act. The Commission supports state preemption in this area.

Broker-Dealer Margin. In a related area, S. 1815 does not include amendments that appear in H.R. 3005 concerning margin requirements for broker-dealers. The Commission and representatives from the securities industry recommended these provisions, which would remove legislative restrictions on the sources from which broker-dealers may obtain financing. These provisions also would exempt from the Federal Reserve Board's margin requirements the extension, maintenance or arrangement of credit for a broker-dealer or a member of a national securities exchange if (1) a substantial portion of the broker-dealer's or exchange member's business consists of transactions with persons other than broker-dealers or (2) such credit is used to finance the broker-dealer's or exchange member's securities activities as a market maker or underwriter. The Commission supports these margin changes.

B. Issues Raised by Amendments to the Investment Company Act

Overview. A substantial portion of S. 1815 would effect important changes to the Investment Company Act of 1940, the primary statute that governs mutual funds and other pooled investment vehicles. Many of these changes were proposed in the Commission staff study on the Investment Company Act.² These changes in the Investment Company Act are proposed at an appropriate time -- over a quarter of a century has passed since the Act was last significantly revised by the Congress. The changes in the investment company industry since 1970 have been dramatic. Nearly one-third of all U.S. households own investment company shares, a fact that attests to the enormous significance of the industry to our

country's economy and its citizens. The trust in investment companies is based in no small part on the strong framework for investment company regulation provided by the Investment Company Act, a law which the fund industry's leading trade association has termed "a model of effective legislation."³

S. 1815 would improve, and help bring into the 21st century, many aspects of investment company operation and regulation. The bill would accomplish the following objectives:

- allow the Commission to make its advertising rules more flexible;
- authorize the Commission to adopt rules to address deceptive and misleading fund names;
- make more flexible the Investment Company Act's provisions concerning "funds of funds" and certain types of insurance products that are regulated as investment companies;
- improve the system under which mutual funds pay their registration fees under the Securities Act;
- simplify the existing exception from Investment Company Act regulation for "private" investment companies with no more than 100 investors;
- create a new exception for investment pools whose only shareholders are highly sophisticated investors; and
- create greater flexibility for investment companies that invest primarily in small businesses.

Additional Amendments Suggested for S. 1815. While the Commission supports the changes proposed in S. 1815, the Commission also believes that further changes to the Investment Company Act are needed in order to improve the Commission's oversight of the investment company industry. H.R. 3005 contains additional amendments to the Investment Company Act that would provide the Commission the tools it needs to function effectively in

today's complex market environment. The Commission urges that these provisions – which include increased authority with respect to recordkeeping, inspections, and shareholder reports – be included in S. 1815.⁴

Recordkeeping and Inspections. The fund industry and the Commission agree that the success of the investment company industry depends greatly on public trust, and also agree that public trust is furthered by an effective Commission inspections program.⁵ The continued success of this program depends on the Commission's access to all documents needed to determine whether funds are meeting regulatory requirements. The Commission's existing statutory basis for fund recordkeeping and inspections, however, is relatively narrow. The Investment Company Act currently permits the Commission to inspect records that funds are required to maintain by Commission rule.⁶ The Act, in turn, limits the Commission's rulemaking authority to records that relate to the fund's financial statements.⁷ Although most funds voluntarily provide all materials that the Commission staff requests, voluntarism is no basis for effective oversight.

H.R. 3005 contains provisions that would enable the Commission to specify, by rule, the information that must be reflected in investment company records.⁸ This approach would strengthen the inspections program and elevate it to the standards that currently apply to inspections of broker-dealers and investment advisers.⁹ The Commission could use this rulemaking authority to facilitate examinations of fund transactions that present novel investor protection issues. For example, the use of derivative investments, which often involves complex strategies, can only be understood by reviewing records unrelated to the financial statements. A complementary provision would clarify the Commission's authority to receive

more frequent reports about material events concerning an investment company (such as a change in control).¹⁰ This provision would enable the Commission, upon learning of such events, to take appropriate action, if necessary, to protect and preserve fund assets.

Shareholder Reports. Finally, H.R. 3005 would broaden the Commission's authority to prescribe the content of semi-annual reports to fund shareholders.¹¹ With this augmented authority, the Commission would be able to require that such reports contain certain important information, such as a fund's investment activities underlying its recent performance results.¹² This information may also help reduce the length and complexity of fund prospectuses. The Commission supports this enhanced authority.

* * *

Collectively, these provisions could significantly improve investment company regulation. They are particularly important to the Commission's ability, in the face of limited resources, to oversee a growing industry. In addition, these provisions reflect the Commission's sensitivity to imposing unnecessary burdens on investment companies, as well as its recognition that investment company internal compliance programs can operate most effectively in an atmosphere that promotes candor. These provisions would complement the other Investment Company Act amendments of S. 1815 discussed in the attached appendix.

IV. Conclusion

The Commission is pleased that S. 1815 continues the dialogue to develop securities legislation that would update and modernize the laws that govern this nation's vibrant securities industry. The Commission takes very seriously the directive to "reinvent"

government, and it has already begun to take important steps to reduce bureaucracy, streamline regulatory requirements and eliminate regulatory burdens.

The Commission strongly supports the thrust of S. 1815 and its counterpart bill in the House of Representatives, H.R. 3005. The Commission also appreciates the provisions of S. 1815 that break new ground in improving securities regulation. As this Congress draws to a close, it is constructive to focus efforts on achieving legislation this session that largely achieves results we all identify as important. The Commission is enthusiastic about working with the Committee, as well as other interested parties, on the many significant issues raised by these bills. Our success will be measured by the efforts we share to enhance capital formation, while preserving the investor protections that are so crucial to our financial markets.

ENDNOTES

1. This figure does not include the roughly 5,000 registered investment companies (representing over 23,000 separate portfolios) that also raise capital in the U.S. markets.
2. See U.S. SECURITIES AND EXCHANGE COMMISSION, DIVISION OF INVESTMENT MANAGEMENT, *PROTECTING INVESTORS: A HALF CENTURY OF INVESTMENT COMPANY REGULATION* (May 1992).
3. *Oversight Hearings on the Mutual Fund Industry: Hearings Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing, and Urban Affairs*, 103d Cong., 1st Sess. 94 (1993) (prepared statement of Matthew P. Fink, President, Investment Company Institute).
4. In his floor statement on S. 1815, Senator Bryan characterized these sections as "key provisions" of H.R. 3005. 142 CONG. REC. S5598 (daily ed. May 23, 1996).
5. See, e.g., *Mutual Fund Industry: Hearings Before the Subcomm. on Telecommunications and Finance of the House Comm. on Energy and Commerce*, 103d Cong., 1st Sess. 99-100 (July 22, 1993) (statement of Matthew P. Fink, President, Investment Company Institute).
6. Investment Company Act section 31(b), 15 U.S.C. § 80a-30(b).
7. Investment Company Act section 31(a), 15 U.S.C. § 80a-30(a); Investment Company Act rule 31a-1, 17 CFR § 270.31a-1.
8. Section 207 of H.R. 3005 (amending Investment Company Act section 31(a), 15 U.S.C. § 80a-30(a), to require investment companies to keep such records as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors). H.R. 3005 also would amend section 31(b) of the Investment Company Act to allow examiners to obtain copies of fund records without seeking a formal order.
9. See Securities Exchange Act sections 17(a) and (b), 15 U.S.C. §§ 78q(a)-(b) (requiring broker-dealers to produce such records as the Commission may prescribe by rule); Investment Advisers Act section 204, 15 U.S.C. § 80b-4 (imposing a similar requirement on investment advisers).
10. Section 206 of H.R. 3005 (amending Investment Company Act section 30(b), 15 U.S.C. § 80a-29(b)).

11. Section 206 of H.R. 3005 (amending Investment Company Act section 30(d), 15 U.S.C. § 80a-29(d), which currently limits the Commission's authority to prescribing the content of financial statements contained in annual reports).
12. Such rulemaking would be particularly beneficial for the shareholders of closed-end funds who, unlike their mutual fund counterparts, receive updates on fund activities only in the form of annual reports.

APPENDIX

SEC ANALYSIS AND RECOMMENDATIONS ON S. 1815

I. Title I – Investment Advisers Integrity Act

A. Section 102 – Funding for Enhanced Enforcement Priority

Section 102 authorizes an appropriation of \$16 million for the enforcement of the Investment Advisers Act of 1940 ("Investment Advisers Act") for each of fiscal years 1997 and 1998.

Commission Recommendation. The Commission opposes this provision.

The Commission strongly supports full and adequate funding for its investment adviser regulatory program, and has testified strongly in favor of increased funding for this program.¹ However, the Commission believes that the amount specified in this provision for enforcement of the Investment Advisers Act appears to be based on a set of assumptions that may not exist if S. 1815 is passed (and the states assume the responsibility for the bulk of the adviser population). Moreover, as a general matter, the Commission believes that funding for its adviser program needs to be viewed and examined in the context of all the Commission's programs -- particularly at a time when the Commission's responsibilities to the rapidly-expanding securities markets are increasing, and overall governmental resources are decreasing.

The SEC is a small agency with an extremely large mission -- overseeing the fast-moving U.S. capital markets, worth trillions of dollars, that fuel the U.S. economy. The Commission does so with modest staff and limited resources, operating in partnership with the private sector self-regulatory organizations ("SROs"), rather than through pervasive regulation. In recent years, recognizing the need for fiscal restraint throughout government, the agency has kept its budget essentially "flat," while the industry and the investing population have grown dramatically. The Commission is willing to continue to take on that challenge, but the Commission needs stability in our overall funding and flexibility in allocating our overall resources to meet that goal.

Thus, the Commission would strongly support reauthorization for the agency for all of its programs. Towards that end, the Commission has supported H.R. 2972, which reauthorizes the Commission for fiscal year 1997 for a total amount of \$317 million. That bill also contains provisions designed to stabilize the Commission's fees and funding structure -- which have been the subject of controversy in recent years. We understand that the related issues of the Commission's fees and funding structure continue to raise questions. However, in the absence of a more comprehensive approach to SEC funding, the Commission does not support dealing with reauthorizing its programs in a piecemeal manner.

B. Section 103 – Improved Supervision Through State and Federal Cooperation

Section 103 of S. 1815 calls for states to assume a primary role with respect to those advisers that are small businesses.² Larger advisers – those with over \$25 million under management – would remain registered with the Commission and would be relieved from state registration and regulation. The Commission would continue to regulate smaller advisers that are based in the few states that do not regulate investment advisers and could continue to bring anti-fraud actions against investment advisers that are registered with the states.

Commission Recommendation. The Commission supports this provision.

Today, there are approximately 22,500 investment advisers registered with the Commission. The ranks of registered investment advisers have increased by over 500% since 1980, far outstripping the growth in the Commission's examination resources. As a result, smaller investment advisers are now examined, on average, once every 44 years – which means that they are not inspected at all.

There is clearly room – and a pressing need – for states to play an important role with respect to the regulation of small investment advisers. The Commission supports the approach taken in S. 1815, a system of jurisdiction sharing, under which state regulators would assume primary responsibility for examining small advisers that are primarily local businesses. Larger advisers, with national businesses, would remain registered with the Commission and would be relieved from state registration and regulation.

The Commission supports S. 1815's innovative approach to one of our major concerns – assuring adequate oversight of the growing investment adviser and financial planner professions.³ Today, many advisers hold themselves out to the public as "REGISTERED WITH THE SEC," a phrase likely to invoke the image of respectability and of Commission oversight. In light of the existing practical realities of inspections, confidence placed in an adviser based solely on registration with the Commission is misplaced.

The approach taken in S. 1815 recognizes the limited resources of the Commission and the states and that those resources can best be utilized to protect clients of investment advisers if overlapping regulatory responsibilities are eliminated. Based upon data filed with the Commission, states would assume primary responsibility for over 16,000 investment advisers (or almost 72% of Commission registrants). We estimate that the approximately 6,300 investment advisers that would remain under Commission supervision manage approximately 95% of the almost \$8 trillion currently overseen by investment advisers.⁴ Thus, under S. 1815's approach, the Commission could concentrate its resources on those advisers that typically have national businesses that can have significant effects on the nation's capital markets.

Section 103 would preempt state regulation (except the enforcement of anti-fraud laws) with respect to Commission-registered advisers as well as advisers that are specifically excepted from the definition of investment adviser. The section would also preempt state regulation of persons who are employed by Commission-registered advisers, *i.e.*, persons associated with investment advisers. The effect of this provision is that these persons will not be subject to state testing and competency requirements. This raises the question whether federal standards for competency ought to be established. We intend to study this issue and will report back to you on our conclusions.

Section 103 also contains a provision allowing the Commission to grant exemptions from the prohibition against registration with the Commission.⁵ This authority could be an important source of flexibility, permitting advisers that have national businesses, but that do not have \$25 million under management, to nonetheless register with the Commission (and not with the states). This authority would enable the Commission, for example, to address circumstances in which an adviser temporarily does not have \$25 million under management. In this case, it would be burdensome for the adviser to register with the states only to deregister a short time later and re-register with the Commission. In addition, the Commission could use the authority to smooth the transition process after the passage of S. 1815 (for example, by allowing advisers in a particular state, at the request of that state, to remain registered with the Commission while that state upgrades its adviser registration laws).

Finally, Section 103 would facilitate the creation of a national filing repository for investment adviser registrations.⁶ Even under the regulatory scheme contemplated by S. 1815, many advisers would continue to make filings with the states as well as with the Commission. Advisers and regulators could realize substantial efficiencies in a one-stop filing system. A similar system is operated by the National Association of Securities Dealers, Inc. for registered representatives of broker-dealers and has been very successful in reducing paperwork for the industry and the regulators.

C. Section 104 -- Interstate Cooperation

Section 104 would limit states to enforcing (1) books and records and (2) financial responsibility laws of the "home" state of the investment adviser to ensure uniformity.

Commission Recommendation. The Commission recommends that the Committee consult with the states regarding this provision.

Although this provision does not involve the Commission directly, we do note that limitations on state recordkeeping might impair efforts by some states to regulate within their borders. For example, the "home" state may not require the adviser to keep records of its employees by location. Therefore, a particular state might not be able to get a list of employees doing business in that state from an adviser whose home state does not require that the adviser keep that information in that format. The Commission suggests that the

Committee consult closely with the states regarding any practical issues raised by this provision.⁷

D. Section 105 -- Disqualification of Convicted Felons

This provision would allow the Commission to deny or withdraw the registration of any person convicted of a felony (or of any adviser associated with such a person).⁸

Commission Recommendation. The Commission supports this provision.

The Investment Advisers Act now identifies only specific crimes primarily involving financial matters or theft. Thus, an embezzler could be barred from the advisory industry, but not a convicted murderer. In a few cases, the Commission has had some difficulty in keeping an obviously unfit felon from registering. This new authority would eliminate this problem.

II. Title II -- Facilitating Investment in Mutual Funds

A. Section 202 -- Funds of Funds

Section 202 would amend section 12(d) of the Investment Company Act of 1940 ("Investment Company Act") to address two types of arrangements that involve investments by a registered investment company in another registered investment company. Section 12(d) currently limits the extent to which one investment company ("acquiring fund") may invest in another investment company ("acquired fund"). Section 202 would exempt from this provision fund of funds arrangements that involve funds that are part of the same "group" of investment companies. This section also would give the Commission additional exemptive authority to address new types of fund of funds arrangements.

Section 202 also amends section 12(d)(1)(E), which addresses situations in which an acquiring fund invests all of its assets in a single acquired fund. The amendment would clarify the application of certain shareholder voting procedures specified in section 12(d)(1) to acquiring funds that are registered with the Commission.

Commission Recommendation. The Commission supports this provision.

In 1970, the Investment Company Act was amended to restrict fund of funds arrangements in response to concerns that arrangements of this sort prevalent at that time had resulted in excessive layering of fees and abuses of control arising from the concentration of voting power in the acquiring fund.⁹

A new type of fund of funds, involving a fund that invests in other funds in the same group or "family" of funds, has been popular with investors recently. These arrangements appear to be attractive because they offer investors a way to diversify their fund investments

through a single, professionally managed portfolio.¹⁰ The Commission has recently granted individual exemptions from the Investment Company Act's restrictions to several similar fund of funds arrangements, subject to conditions designed to address the concerns upon which the restrictions were premised (*i.e.*, overly complex corporate structures and excessive distribution fees).¹¹

The Commission supports this amendment to section 12(d) of the Investment Company Act. S. 1815 would incorporate certain of the conditions in the Commission's orders into a statutory exemption from section 12(d)(1) and would enable fund of funds arrangements involving a group of investment companies to be offered without obtaining prior exemptive relief from the Commission.¹² The provision also would give the Commission authority to adopt rules to fill any gaps in investor protection or to address any abuses arising in connection with the new fund-of-funds exemption. In addition, the Commission would be able to use its authority under the Securities Act of 1933 ("Securities Act") to require full disclosure of the acquiring fund's expense structure (for example, by requiring an acquiring fund to disclose in the prospectus fee table the cumulative advisory fees paid by the acquiring and acquired funds).

S. 1815 also would give the Commission greater authority to exempt other types of fund of funds arrangements from the Investment Company Act's restrictions. The Commission, for example, could use this authority to issue a rule exempting arrangements that involve funds that are not part of the same fund family or that otherwise do not fall within the new exemptive provision.

The Commission also supports the amendment in S. 1815 that addresses shareholder voting procedures for funds that rely on section 12(d)(1)(E). Section 12(d)(1)(E) is used in arrangements (such as "master-feeder" fund arrangements) designed to facilitate the acquired fund's access to alternative distribution channels to sell its shares. In a master-feeder arrangement, one or more funds ("feeder" funds) invest solely in the shares of another fund ("master" fund). When a matter is submitted, generally by the master fund's directors, for approval by the master fund's shareholders, the Investment Company Act, in certain instances, requires feeder funds to seek voting instructions from their shareholders and vote accordingly ("pass-through voting").¹³ This provision seeks to place control of matters that fundamentally affect the master fund's operations and investments in the hands of the feeder funds' shareholders.¹⁴

Because the master-feeder voting provision initially was enacted to address concerns about unregistered foreign funds investing in and exercising control over U.S. funds, it applies only to unregistered feeder funds.¹⁵ S. 1815 would recognize that feeder funds' shareholders should have a voice in the fundamental decisions affecting the master fund in all cases.¹⁶

B. Section 203 -- Flexible Registration of Securities

Section 203 of S. 1815 would amend section 24 of the Investment Company Act, which relates to the registration of investment company securities under the Securities Act. The amendments would implement a new system under which mutual funds and certain other types of investment companies would pay registration fees under the Securities Act. A fund would be required to pay its registration fees to the Commission within 90 days after the end of its fiscal year based upon the net sales of the fund for that fiscal year. A fund that missed the filing deadline would be required to pay interest on the amount due, at the rate established by the Secretary of Treasury under the Debt Collection Act of 1982.

Commission Recommendation. The Commission supports this provision, with one reservation regarding its effective date.

Mutual funds and certain other types of investment companies sell and redeem their shares on a continuous basis. The Commission has adopted rules that permit funds to offset (or "net") sales against redemptions for purposes of calculating the registration fees that must be paid on these shares under the Securities Act. While this approach can substantially reduce fees, the Investment Company Act contains provisions that require the Commission's rules to impose rather severe consequences if certain filing deadlines are not met. Failure to pay these fees within 60 days precludes a fund's netting of sales against redemptions for purposes of fee calculations, resulting in significantly higher registration fees.¹⁷ Failure to pay the fees within 180 days could result in the fund's being deemed to have sold unregistered securities.¹⁸ These penalties are not designed to protect the interests of fund shareholders; rather, they reflect a mismatch of the fee payment structure of the Securities Act and the reality of fund operations.

S. 1815 would implement a new, simpler system for the payment of registration fees. This system would insure that mutual funds would not be deemed to have sold unregistered securities or lost the ability to net redemptions against sales simply because the registration fee was paid late. The provision requiring that interest be paid on late filings should encourage timely filing and would compensate the U.S. Treasury for any delay in the receipt of revenues.

The Commission's one reservation concerning the provision relates to its effective date. The provision would become effective 180 days after the date of enactment of S. 1815. The Commission believes this would not be a sufficient amount of time for the Commission to review its rules and reprogram its systems to accommodate the changes. We request, therefore, that the effective date be extended to one year or upon such earlier date as the Commission may specify by rule.

C. Section 204 – Facilitating the Use of Current Information in Advertising

Section 204 would add subsection (g) to section 24 of the Investment Company Act to expressly authorize the Commission to permit investment companies to use a new type of "advertising" prospectus for purposes of section 5(b)(1) of the Securities Act.

Commission Recommendation. The Commission supports this provision.

Advertising is particularly important to mutual funds because they continuously offer and sell their shares to the public. Like other public issuers of securities, funds are subject to the advertising requirements of the Securities Act. That regulatory scheme, however, has proved to be problematic when applied to fund advertising.

Currently, funds may advertise performance data and other information, so long as the "substance of" that information is contained in the fund's prospectus. As a result of the "substance of" requirement, funds often cannot advertise matters of investor interest, such as policies that a fund will not hold particular instruments, such as derivatives, for example, or the effect of economic conditions on the fund's investment policies, since these matters may not have been addressed in the fund's prospectus and related statement of additional information.¹⁹ Funds often attempt to avoid this result by cluttering their prospectuses (or related statements of additional information) with information they may later want to include in advertisements.

This provision of S. 1815 would improve fund advertising by giving the Commission express authority to create a new investment company "advertising prospectus." The amendment would enable funds to use such a prospectus to show performance data and other information unrestricted by the "substance of" requirement. The advertising prospectus generally would be subject to the liability provisions of the Securities Act applicable to prospectuses.²⁰ This provision should further the Commission's efforts to develop shorter, more "investor-friendly" disclosure documents, since advertisements would no longer be tied to the contents of a fund's prospectus. The provision also may increase the amount of information about funds that reaches investors, which should, in turn, benefit investors and funds.

D. Section 205 – Variable Insurance Contracts

Section 205 would amend sections 26 and 27 of the Investment Company Act as they relate to the regulation of variable insurance contracts. These investment products generally must meet the provisions of the Investment Company Act governing periodic payment plans.²¹ S. 1815 would recognize that variable insurance contracts fundamentally differ from periodic payment plans and should not be treated identically under the Investment Company Act.

Commission Recommendation. The Commission supports this provision.

Variable insurance contracts, developed well after the adoption of the Investment Company Act, have experienced exponential growth in recent years. The application of the Investment Company Act's provisions governing periodic payment plans to these products has been difficult, resulting in the regulatory equivalent of fitting a square peg into a round hole.

With respect to variable insurance contracts, S. 1815 would replace the specific limits on the amount, type, and timing of charges that apply to periodic payment plans with more general prohibitions against excessive fees similar to those applied to mutual funds under the Investment Company Act.²² Aggregate charges under variable insurance contracts would have to be "reasonable."²³ S. 1815 also would give the Commission explicit rulemaking authority that could be used to address any potential abusive practices.

E. Section 206 -- Prohibition on Deceptive Investment Company Names

Section 206 would amend section 35(d) of the Investment Company Act to grant the Commission rulemaking authority to define investment company names or the title of the securities they issue as materially deceptive or misleading.

Commission Recommendation. The Commission supports this provision.

In selecting mutual funds, investors often focus on fund names as a way of determining the fund's investment objective and level of risk, often to their detriment. Fund names, for example, that include the word "government," "guaranteed," or "insured" may in some cases cause investors to conclude, incorrectly, that their investments are guaranteed by state or federal governmental authorities.

Although the Investment Company Act currently prohibits funds from using misleading or deceptive names, the means provided in the Act for enforcing this provision are antiquated and burdensome. The Act requires the Commission to find, and declare by order, that a fund's name is deceptive or misleading, and then bring an action in federal court to enjoin the use of the name.²⁴ This process is potentially cumbersome and rarely has been used by the Commission. S. 1815 would give the Commission a more effective and efficient means of handling this problem by authorizing the Commission to address these practices by rule.²⁵ Such rulemaking would help achieve clarity in labeling that benefits investors and funds alike.²⁶

F. Section 207 -- Excepted Investment Companies

Section 207 would amend section 3(c)(1) of the Investment Company Act, which exempts from the Act's regulation investment funds that do not publicly offer their securities and have no more than 100 investors ("section 3(c)(1) funds"). Section 207 also would add new Sections 3(c)(7) and 2(a)(51) to the Investment Company Act for purposes of creating a

new exception from the Act's regulation for investment funds designed for financially sophisticated "qualified" investors ("qualified purchaser pools").

Commission Recommendation. The Commission generally supports this provision, with certain reservations.

Amendments to Section 3(c)(1). The Commission supports this provision.

Section 3(c)(1) currently exempts from registration and regulation under the Act any fund that has no more than 100 investors and does not publicly offer its securities.²⁷ These limitations were designed to ensure that funds exempted from regulation in this manner are sufficiently private in nature. S. 1815 would simplify the complex test now used to calculate a section 3(c)(1) fund's 100 investor limit. Under the current test, a section 3(c)(1) fund may have to include within the 100 investor limit the shareholders of certain corporate investors in the fund.²⁸ In practice, section 3(c)(1) funds avoid application of this "look through" provision by restricting corporate investments to less than 10% of their securities. As amended, section 3(c)(1) would no longer require a section 3(c)(1) fund to count the underlying shareholders of its corporate, non-investment company investors under any circumstances. This change in the law is warranted because such investors are unlikely to be mere conduits intended to enable a section 3(c)(1) fund to have indirectly more than 100 investors.

Qualified Purchaser Pool Provision. The Commission generally supports this provision, with certain reservations.

S. 1815 would create a new exception from registration and regulation under the Act for investment pools whose shareholders are all highly sophisticated, "qualified purchasers." These new pools, while prohibited from making public offerings, would not be required to limit the number of their investors. The Commission supports an exception from Investment Company Act regulation for qualified purchaser pools.

The qualified purchaser pool concept would recognize that financially sophisticated investors are in a position to appreciate the risks associated with investment pools that do not have the Investment Company Act's protections.²⁹ These investors generally can evaluate on their own behalf matters such as the level of a fund's management fees, governance provisions, transactions with affiliates, investment risk, leverage, and redemption rights.

S. 1815 would define a qualified purchaser as any natural person who owns at least \$5 million in "investments," or any other person (e.g., an institutional investor) that owns and manages on a discretionary basis at least \$25 million in investments.³⁰ The Commission would be required to define what constitutes an investment for purposes of meeting these thresholds.³¹ The Commission also would have rulemaking authority to define additional persons as qualified purchasers (i.e., persons that do not meet the statutory threshold) based on factors that relate to the person's financial sophistication.³² In addition,

provisions of S. 1815, however, may open qualified purchaser pools to persons who do not themselves meet the standards of sophistication reflected in the qualified purchaser exception.

Subject to these reservations, the Commission supports the general approach in S. 1815. This approach would codify thresholds of financial sophistication, while enabling the Commission to adjust these thresholds in response to changing financial conditions or take other appropriate action based on its administrative experience with the qualified purchaser exception.

G. Section 208 -- Performance Fee Exemptions

Section 208 would amend section 205 of the Investment Advisers Act to except investment advisory contracts with qualified purchaser pools from the Act's prohibition on performance fees. Section 208 also would amend section 205 to give the Commission explicit authority to exempt from the performance fee prohibition investment advisory contracts with sophisticated clients and clients that are not residents of the United States.

Commission Recommendation. The Commission supports these provisions.

The Investment Advisers Act generally prohibits a registered investment adviser from receiving compensation on the basis of a share of capital gains in or capital appreciation of a client's account.³⁹ Commonly referred to as performance based compensation or a "performance fee," this type of compensation arrangement can take various forms. A fee equaling 10% of an account's gains, for example, or a fee of 20% of all the gains in an account exceeding the performance of a designated securities index or other bench mark is a type of performance fee.

The prohibition on performance fees was included in the Investment Advisers Act because of Congress' concern that performance fees created incentives for advisers to take undue risks in managing a client's account in order to increase advisory fees.⁴⁰ In 1970, Congress concluded that performance fees were not necessarily undesirable in all cases and exempted from the performance fee prohibition a type of fee known as a "fulcrum fee."⁴¹ Investment advisers may enter into fulcrum fee arrangements with registered investment companies or persons with at least \$1 million in assets. Commission rules also provide a limited exemption from the prohibition for advisory contracts with clients having at least \$500,000 under management or a net worth exceeding \$1 million.⁴²

The level of sophistication of the investors in a qualified purchaser pool suggests that this kind of issuer should be allowed to enter into a fee arrangement that is not a fulcrum fee. S. 1815 also would allow the Commission greater flexibility, for example, to exempt from the prohibition advisory contracts with institutional clients that can appreciate the risks of performance fees and are in a position to protect themselves from overreaching by the adviser.

Finally, this provision would recognize that advisers should not be prohibited from entering into performance fee contracts with their foreign clients, particularly when such arrangements are legal and customary in a client's country of residence. This provision also would help eliminate the competitive disadvantage experienced by U.S. investment advisers unable to enter into customary performance fee arrangements with foreign clients.⁴³

III. Title III -- Reducing the Cost of Saving and Investment

A. Section 301 -- Exemption for Economic, Business, and Industrial Development Companies

Section 301 of S. 1815 would create an exemption under the Investment Company Act for a company whose activities are limited to the promotion of economic, business, or industrial development of enterprises doing business in the state in which the company is organized.⁴⁴ Such a company could sell its securities only to accredited investors as defined in the Securities Act⁴⁵ and rules thereunder and to other persons authorized by the Commission. In addition, the company could not issue redeemable securities, and would be required to sell at least 80% of its securities to residents of the state in which the company is organized. Companies relying on this exemption would be subject to certain restrictions on the purchase of securities issued by an investment company.

Commission Recommendation. The Commission supports this provision.

The Commission believes it appropriate to create an exemption from federal regulation for these companies, which are designed to stimulate local economies by providing direct investment and loan financing, as well as managerial assistance, to different types of state and local enterprises. To date, the Commission has used its exemptive authority under the Investment Company Act to exempt from some or all of the Act's provisions 15 companies organized for the purpose of providing financing and managerial assistance to local businesses. S. 1815 would eliminate the need for such companies to seek exemptive orders.

This proposal is premised on states having a strong interest in these companies' operations. At least 80% of the company's securities would have to be sold to a particular state's residents.⁴⁶ Further, to qualify for the proposed exemption, a company would have to be regulated under a specific state statute and organized under the laws of that state. Forty-four states now have statutes specifically authorizing the creation of these companies. Because some state statutes provide comprehensive regulation, while others are less substantive, S. 1815 would authorize the Commission to supplement state provisions when necessary to respond to investor protection concerns.

S. 1815 also contains a number of other investor protection requirements. In particular, to avoid confusion between an exempt company and an open-end fund registered under the Investment Company Act that also limits itself to making investments within a

state, an exempt company would be prohibited from issuing redeemable securities. In addition, an exempt company could sell its securities only to accredited investors and other persons authorized by Commission rule or order.

B. Section 302 – Intrastate Closed-end Investment Company Exemption

Section 302 of S. 1815 would expand the Commission's authority to exempt from Investment Company Act regulation closed-end funds that publicly offer their securities solely within a particular state, by increasing the aggregate offering amount of securities that could be offered by these companies from \$100,000 to \$10,000,000.⁴⁷

Commission Recommendation. The Commission supports this amendment.

The Commission currently is authorized to exempt an intrastate closed-end fund from some or all of the Investment Company Act's provisions so long as the aggregate proceeds of completed and proposed offerings do not exceed \$100,000. This limit was set in 1940 and never has been changed. To reflect the capital needs of intrastate funds in today's financial markets, S. 1815 would increase the aggregate offering amount to \$10 million or such other amount as the Commission may set by rule or order.⁴⁸

C. Sections 303-307 – Business Development Companies

Sections 303 through 307 of S. 1815 would amend certain provisions of the Investment Company Act that pertain to business development companies. Section 303 would amend the definition of "eligible portfolio company," in which business development companies invest, to include any company that has total assets of \$4 million or less and capital and surplus of not more than \$2 million, and any other company that meets criteria prescribed by Commission rule ("small eligible company").⁴⁹ Section 304 would amend the definition of "business development company" to provide that a business development company does not have to make available significant managerial assistance to a small eligible company.⁵⁰ Section 305 would permit business development companies to purchase the securities of companies that do not qualify for margin listing under Federal Reserve Board regulations, from any person, rather than having to acquire these securities directly from the portfolio company itself or its affiliated persons.⁵¹ Section 306 would modify the current capital structure restrictions on business development companies to permit them to issue more than one class of debt, to issue short-term warrants, options or rights that are accompanied by any other security, and to issue long-term warrants, options or rights on a stand-alone basis.⁵² Finally, Section 307 would authorize the Commission to require business development companies to supply shareholders annually with a written statement describing the risk factors associated with their capital structures.⁵³

Commission Recommendation. The Commission generally supports these provisions, with certain reservations.

Business development companies or "BDCs" are closed-end funds⁵⁴ that invest in small and developing businesses.⁵⁵ Unlike traditional investment companies that invest without becoming actively involved in the management of their portfolio companies, BDCs are required by the Investment Company Act to offer significant managerial assistance to their portfolio companies.⁵⁶ These amendments would provide BDCs with more flexibility in a number of respects and may result in additional investment in small businesses.⁵⁷

The Commission regulates BDCs in a manner similar to registered investment companies. BDCs, however, are not required to register with the Commission as investment companies, and generally are permitted greater flexibility in dealing with their portfolio companies, issuing and pricing securities, and compensating management.⁵⁸

Although they were envisioned as a public alternative to private venture capital firms, BDCs have drawn only limited public investor interest.⁵⁹ In 1993, there were only about 44 active BDCs with assets of about \$2.5 billion. In 1995, the number of active BDCs increased to 60, but the assets under management declined to \$2.1 billion. S. 1815 would change BDC regulation to make it easier and less costly for BDCs to offer securities and to invest in small businesses. S. 1815 would create a new class of portfolio companies in which BDCs could invest without making available "significant managerial assistance," permit BDCs to acquire more freely the securities of portfolio companies, and allow BDCs greater flexibility in their capital structure.

New Class of Small Portfolio Companies. The time and expense involved in providing managerial assistance to companies having low levels of total assets and market capitalization may deter BDCs from investing in them. These companies, however, often are most in need of capital. To address this issue, S. 1815 would create a new class of portfolio companies in which BDCs could invest without making available significant managerial assistance. This new class would include any company that has total assets of \$4 million or less and capital and surplus of not more than \$2 million,⁶⁰ and any other company that meets criteria prescribed by Commission rule.

Acquisitions of Securities. S. 1815 also would permit BDCs to acquire more freely the securities of portfolio companies. Currently, BDCs must monitor their portfolios to assure that at least 70% of their assets are invested in cash, securities of financially troubled businesses, and securities of "eligible portfolio companies."⁶¹ Eligible portfolio companies, to which BDCs must offer managerial assistance, are companies that the BDC controls or companies that do not qualify for margin listing under Federal Reserve Board regulations. Currently, the securities of portfolio companies that do not qualify for margin listing must be acquired directly from the companies or their affiliated persons.⁶² The provision would permit BDCs to acquire these securities from any other person, potentially increasing the liquidity of such securities.

Capital Structure Amendments. Finally, S. 1815 would amend the Investment Company Act to permit BDCs greater flexibility in their capital structure. S. 1815 would

permit BDCs to issue, without restriction, multiple classes of debt securities. A BDC currently may issue more than one class of debt only if all of its debt securities are privately held or guaranteed by financial institutions, and the BDC has no intent to distribute publicly any class of debt securities. S. 1815 would permit public investors to participate in offerings of multiple classes of debt.

S. 1815 also includes two provisions that would ease restrictions on a BDC's ability to issue warrants, options, or rights. Currently, BDCs may issue only (1) short-term warrants, options, or rights to their security holders, or (2) warrants, options, or rights that expire within ten years and are accompanied by debt securities. S. 1815 would permit BDCs to issue warrants, options, or rights that expire within ten years if they are accompanied by any other securities, including equity securities, issued by the BDC. S. 1815 further would allow BDCs to issue long-term warrants, options, or rights on a stand-alone basis, subject to certain conditions.

Finally, to address the additional risks associated with the proposed capital structure amendments, S. 1815 would authorize the Commission to require BDCs annually to supply shareholders with a written statement describing the risk factors associated with their capital structures.

D. Section 308 – Facilitating National Securities Markets

Section 308 of S. 1815 contains proposed amendments to the federal securities laws that would preempt in specific circumstances state requirements with respect to securities registration. Under S. 1815, the following types of offerings are preempted:

- Securities issued by investment companies in transactions registered under the Securities Act;
- Securities listed on the New York Stock Exchange, the American Stock Exchange, and the National Association of Securities Dealers Automated Quotations ("NASDAQ") National Market System, as well as categories of securities listed on other exchanges or trading systems, as determined by the Commission consistent with the purposes of the title and the protection of investors, provided, in each case, that the securities are registered under the Securities Act; and
- Securities offered and sold to "qualified purchasers," as defined by the Commission.

In those specified areas, the states would not be permitted, directly or indirectly, to require registration or qualification of these securities transactions; prohibit, limit or impose conditions on the use of offering documents; or prohibit, limit or impose conditions upon the offer or sale based on the merits of the offering or the issuer. Instead, in these offerings the

role of the states would be limited to: (1) requiring notice filings and collecting fees with respect to certain securities filings; (2) enforcing anti-fraud provisions; and (3) policing broker-dealer conduct.

Under S. 1815, the preemption for the securities offerings described above (other than investment companies and offers and sales to qualified purchasers) would not apply to specified problematic offerings, such as offerings by blank check companies, partnerships, limited liability companies, penny stock, or roll-up transactions. Also, preemption would not apply if a person associated with the offering is subject to specified statutory disqualifiers.

Commission Recommendation. The Commission supports these securities registration preemption provisions, with one request for clarification and various technical comments.

Consistent with the Commission's position on the comparable provisions in H.R. 3005, the Commission believes that it is appropriate to provide for exclusive federal review of the offerings noted above. States would continue to provide important safeguards in connection with policing fraud in these offerings, and would receive notice filings and fees as specified to facilitate this program. Importantly, the preservation of authority makes clear that states would continue their role in regulating broker-dealer conduct whether or not the offering is preempted from state review. The Commission believes that the ability of the states to continue to oversee broker-dealer conduct in connection with preempted offerings is important to ensure continued investor protection.

Exclusive federal review in the investment company area would provide significant new benefits. State regulation can pose particularly significant obstacles to investment companies, which typically engage in business on a national scale and are constantly in registration. Investment companies, moreover, are comprehensively regulated at the federal level under the disclosure provisions of the Securities Act and the substantive regulatory provisions of the Investment Company Act.

With respect to securities traded on the specified national exchanges, the states have already taken important steps toward eliminating duplicative securities registration requirements by, for the most part, exempting from blue sky regulation companies traded on the New York Stock Exchange, the American Stock Exchange and the National Market System of NASDAQ. The Commission believes it is appropriate to codify these exemptions as proposed in S. 1815.⁶³

One area that does require further clarification, however, is the provision in S. 1815 allowing the Commission to specify that certain categories of securities listed on other exchanges or trading systems would be further preempted from state law registration requirements. The Commission agrees that it is appropriate to extend preemption to future trading systems or categories of securities traded on exchanges, provided that listing or qualification standards are comparable to the listing standards of other exchanges the stock of

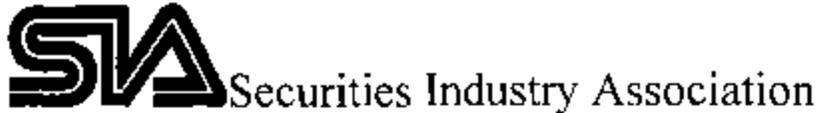
Commission the flexibility to explore and adopt new approaches to registration, disclosure, and related issues.⁶⁷

Two far-reaching initiatives to develop such new approaches are already under way at the Commission. Last year, the Commission established an *Advisory Committee on the Capital Formation and Regulatory Processes* ("Advisory Committee"), which is considering comprehensive reforms of the registration and disclosure process. The Committee's mandate is broad in scope: it is considering, for example, whether Commission rules should permit a registration concept that relies more on company disclosure and market-driven securities disclosure (company registration) rather than on the Commission's mandated transaction disclosure. This approach could both streamline registration and disclosure requirements, while actually enhancing information flow and protections to investors. The Commission expects to receive the Advisory Committee's recommendations in the near future.

The Commission also established an internal *Task Force on Disclosure Simplification* ("Task Force"), which reviewed all forms and all disclosure requirements imposed on public companies. The Task Force – whose outside advisor was Philip Howard, author of a book on regulatory simplification entitled The Death of Common Sense – made its recommendations to the Commission in March of this year. The Task Force recommended eliminating 81 rules and 22 forms and modifying dozens of others. The Commission already has taken action to implement a number of the proposals.

A grant of general exemptive authority under the Securities Act could make it easier for the Commission to implement certain proposals that seek to assist small businesses with capital formation, such as the pending "test-the-waters" proposal. In addition, general exemptive authority could facilitate the implementation of "company registration" following the recommendations of the Commission's Advisory Committee (although it appears at this time that much of the company registration proposal could be implemented, albeit somewhat more awkwardly, under the Commission's existing rulemaking authority).

Similarly, the broad exemptive authority under the Exchange Act, would allow the Commission to provide exemptions from Exchange Act reporting and other provisions, perhaps in tandem with exemptions under the Securities Act. In addition, the Exchange Act exemptive authority would be useful to the Commission in its consideration of issues related to the securities markets more generally. For example, the proposed section would allow the Commission flexibility to address appropriately the regulatory concerns raised by the recent proliferation of electronic trading systems, which do not fit neatly into the existing regulatory framework for exchanges. For example, the Commission would be able to adopt rules exempting certain classes of entities from the exchange registration requirements under the Exchange Act. Proposed Section 309 would also permit the Commission to exempt certain classes of persons from regulation under circumstances in which the activities of such persons would not pose risks to the investing public, including the authority to exempt certain persons from the definition of "broker" and "dealer."⁶⁸



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F. Section 310 – Analysis of Economic Effects of Regulation

Section 310 of S. 1815 would require the Chief Economist of the Commission to prepare a report on each rule proposed by the Commission. This report would include an analysis of the likely costs of the regulation on the securities markets and the participants in those markets, and the estimated impact of the rule on economic and market behavior. Before any rule could become effective, each Commissioner would have to receive a copy of the Chief Economist's report and the report would have to be printed in the Federal Register. This section also would authorize appropriations of \$6 million for each of fiscal years 1997 and 1998 for the Commission's Economic Analysis Program.

Commission Recommendation. The Commission opposes this provision.

The Commission understands the value of economic analysis in considering regulatory alternatives in response to changing market conditions. In this regard, the Commission has just selected a new Chief Economist, and is rapidly increasing the Office of Economic Analysis' staff, as well as its budget – up 50% to \$3 million. In addition, the Director of the Division of Market Regulation is an economist, and the Division of Corporation Finance will be adding an economist to its staff shortly.

In responding adequately to situations that arise in the market through rulemaking, the Commission considers many alternative solutions within its statutory mandate, as well as their potential effects and side effects. Through the notice and comment process, the Commission requests comment on key elements of the proposal, including the costs and benefits of the proposed rule, and whether any burdens the proposed rule imposes on competition are necessary. It uses the information it receives to make judgments in formulating final rules. As part of this analysis, the Commission weighs the costs imposed by a potential rule and the benefits achieved.

Although the Commission considers analysis of the potential costs and benefits an integral part of its rulemaking process, the Commission has several concerns regarding the proposal in this bill. Of greatest concern is that by focusing on a rule-by-rule, amendment-by-amendment analysis, S. 1815 would trivialize the role of economic analysis. Our economists find that, as a general matter, their efforts are better directed toward analyzing the larger economic context and thematic issues that cut across markets. The best approach to evaluating the impact of regulation on market behavior and its costs is on a market-by-market basis, rather than rule-by-rule. The Regulatory Flexibility Act already assumes that there will be some analysis of every rule proposal. This, however, is not an area to which more resources should be dedicated.

As noted in the broader discussion on Section 102, the Commission believes that the Commission's authorization should not be approached in a piecemeal fashion. It would be very difficult for the Commission to direct \$6 million of its budget to the Economic Analysis Program, particularly within a brief two-year period. Moreover, the Commission also is

concerned that in doubling the amount of money authorized for the Economic Analysis Program, other necessary SEC programs would have to be curtailed. Assuming the Commission's total appropriation level stays the same, the Commission would have to cut \$3 million from other programs to achieve the \$6 million spending level specified in S. 1815.

While the Office of Economic Analysis' function is to provide its independent economic views to the Commission and its staff, the Commission believes that it also is important to integrate economists into those Divisions and Offices of the Commission that propose and implement Commission rules, so that economic viewpoints can be considered as policy is developed rather than at the conclusion of a rulemaking. For this reason, if the proposal is nonetheless enacted, it is important that S. 1815 provide the Commission with the flexibility to integrate economists into the staff of those areas of the Commission responsible for those programs without focussing exclusively on the role of the Office of Economic Analysis. However, even under this broader approach to economic analysis, the Commission believes that doubling the funding for this purpose, without increasing the Commission's overall budget, would not well serve the Commission's overall program needs.

G. Section 311 – Privatization of EDGAR

Section 311 would direct the Commission to submit a report to Congress within 180 days concerning Commission plans for promoting competition and innovation of the EDGAR system through privatization of all or any part of the system.

Commission Recommendation. The Commission supports this provision with minor amendments.

As a general matter, the Commission supports promoting competition and innovation of EDGAR through privatization of parts of the system and is prepared to report to Congress on its efforts and plans to accomplish this goal.

The Commission recognizes the importance of EDGAR to the agency's mission and is committed to a fundamental reexamination of EDGAR and how it operates. The Commission staff has spent a considerable amount of time studying the issues and has engaged in numerous outreach programs to the private sector. For example, the Commission held several conferences to obtain the input from EDGAR users (filers, vendors, disseminators, analysts, investors, and others) on how to improve and update the EDGAR system.

In December 1995, the Commission asked the Computer Science and Telecommunications Board of the National Research Council to convene a panel to help the Commission prepare for the redesign of EDGAR. This "brainstorming session," which was attended by nationally recognized computer industry experts, addressed the use of new technology as well as the structure of the system – in particular, how to assure that the system is responsive to the agency's mission while providing incentives for the private sector

to play a greater role. The participants endorsed the Commission's approach in seeking a variety of options for the new system.

The Commission intends to issue a request for proposals ("RFP") shortly to solicit bids on continuing the EDGAR system. It is expected that the Commission will solicit alternative modernization approaches, including approaches that may further privatize the system.⁶⁹ Of course, the current EDGAR information dissemination system is almost completely privatized through a series of private information vendors.

In the search for privatization, however, it is important to recognize that there must be a federal government presence in the EDGAR system, since the Commission staff must receive and have access to the information, including the ability to search the data in order to review the documents required to be filed with the Commission. Therefore, there may be natural limitations on the amount of privatization possible.

The Commission is committed to continue its efforts to consider private solutions, and is prepared to report to Congress on its findings. The Commission is concerned, however, that the specification of the 180-day period for the report is problematic. The 180-day period is troublesome in that it is unlikely that a contract of this magnitude will be awarded within six months of enactment of S. 1815, given the intricacies of the federal procurement process. While a procurement is pending, the Commission is unable to discuss freely the options available and the agency response. The Commission thus suggests that this provision be amended to request the report within the later of 180 days of enactment of S. 1815 or 60 days after the award of the new EDGAR contract.

H. Section 312 -- Improving Coordination of Supervision

Section 312 of S. 1815 would require the Commission and examining authorities for broker-dealers (defined as registered SROs) to eliminate unnecessary and burdensome duplication in the examination process. They would do this through coordination and cooperation. Specifically, S. 1815 directs that the Commission and the examining authorities share information, including non-public regulatory information, as appropriate, to foster a coordinated approach to regulatory oversight of broker-dealers that are subject to examination by more than one SRO.

Commission Recommendation. The Commission supports this provision.

The Commission agrees that duplicative and overlapping examinations impose unnecessary burdens on broker-dealers (and represent an inefficient use of regulatory resources). Accordingly, in recent years, the Commission has placed new emphasis on coordinating examinations of broker-dealers and eliminating areas of duplication. For example, the Commission recently created an Office of Compliance Inspections and Examinations to coordinate better the agency's own examinations, and has begun working

with the SROs in an effort to encourage cooperation among SROs in scheduling examinations.

The Commission strongly supports this provision, which would provide statutory support for its current efforts to eliminate duplication in broker-dealer oversight. In November 1995, the Commission entered into a Memorandum of Understanding with examining authorities to improve their coordination. Section 312 strengthens those efforts. It provides a mandate for better coordination, and a specific statutory authorization for the sharing of information necessary to accomplish this goal.

I. Section 313 – Increased Access to Foreign Business Information

Section 313 of S. 1815 would address the status under the Securities Act and the Exchange Act of offshore press conferences and press related materials. Specifically, for purposes of the Securities Act registration requirements, the definition of "offer" would be amended to exclude press conferences held outside of the United States, public meetings with issuer representatives conducted outside of the United States, or press related materials released outside of the United States in which an offshore offering is discussed. This provision would apply without regard to whether journalists from the United States or journalists for publications (including on-line services) with circulation in the United States attend such press conferences or meetings or receive such press related materials. This provision would apply to all issuers (whether domestic or foreign), and would be available for offshore offerings that are also being made in the United States.

Section 313 also would amend section 14 of the Exchange Act to provide that a "foreign issuer" engaged in a tender offer may grant United States journalists access to such press contacts and press related materials in connection with the tender offer, without triggering the application of the Williams Act tender offer provisions or becoming subject to any regulations promulgated by the Commission pursuant to Section 14(e) (the Williams Act anti-fraud provision) or 13(e) (the issuer tender offer anti-fraud provision), or otherwise, that relate to tender offers or requests or invitations for tender. For purposes of this section, a "foreign issuer" is defined to include any corporation or other organization (1) that is incorporated or organized under the laws of any foreign country; or (2) the principal place of business of which is located in a foreign country.

Commission Recommendation. The Commission supports the purposes of these provisions, but believes these issues should be addressed through Commission rulemaking.

These provisions are designed to address the problem encountered by many United States journalists that such journalists are excluded by issuers from offshore press conferences and materials because of concerns about the application of the U.S. securities laws. Notably, the Commission and its staff have issued several statements in this area

designed to assure market participants of what is permissible in this area. Nevertheless, the Commission understands that United States reporters continue to experience this problem.

The Commission is sympathetic to the frustration of the United States press, and agrees that the issue must be resolved. However, the Commission believes that the concerns are best addressed through Commission rulemaking to assure that the provisions remain flexible so that if any problematic practices develop, this can be addressed in the future. For example, the Commission is concerned that press releases issued offshore could be used abusively as a means of circumventing Securities Act rules that require written offers to be made by the Securities Act prospectus. Under S. 1815, an issuer seeking to evade U.S. prospectus disclosure rules might publicize an offering with "press materials" released just across the U.S. border. Since offshore offerings often include a public or private United States offering, there is a United States interest in assuring that such abusive practices do not develop. If the Commission proceeds with rulemaking, it could do so on a "pilot" basis, and revise the rule in the future if abusive practices develop. The proposed legislative approach would not allow this flexibility.

While the Commission believes that the tender offer provisions also should be addressed through rulemaking for the reasons noted above, the provisions in Section 313 with respect to tender offers raise additional concerns. First, the Commission assumes that this Section affects only rules, such as procedural and disclosure rules, promulgated under sections 14(e) and 13(e) – there would be no effect on the general anti-fraud prohibition in section 14(e). If the Commission's assumption is incorrect, removal of these anti-fraud prescriptions would raise serious concerns for investor protection. Second, in an apparent effort to limit the reach of the exemption, the tender offer provision is limited to "foreign issuers." However, unlike the Commission's definition of "foreign private issuer," the definition of "foreign issuer" would appear to include foreign incorporated issuers with all of their shareholders and/or all of their business in the United States, as well as domestic issuers with all of their shareholders in the United States, as long as their principal place of business is offshore. This definition appears to be overbroad, and would not provide meaningful limitations on the coverage of Section 313 as it relates to tender offers.

J. Section 314 – Short-form Registration

Section 314 of S. 1815 would require the Commission to amend the eligibility criteria for short-form securities registration not later than 180 days after the date of enactment of the Act. In such amendments, the Commission is directed to include non-voting stock (and such other securities as the Commission shall determine) in the calculation of the minimum market capitalization necessary to qualify to use the form for a primary offering.

Commission Recommendation. The Commission supports the concept of allowing non-voting common stock to be included in determining short-form registration eligibility, but believes this should be addressed through Commission rulemaking.

The Commission periodically adjusts the form eligibility requirements for all offerings, including primary offerings eligible for short-form registration, based on its assessment of many factors, including market practices, potential cost savings and investor protection. For example, the Commission substantially changed the eligibility requirements for short-form registration in 1992 (for domestic issuers) and 1994 (for foreign issuers) to make the forms available to a much broader class of issuers.

While short-form registration eligibility for primary offerings historically has been based on the amount of voting common stock held by non-affiliates, the Commission has no objection to including non-voting common stock in the calculation. However, the Commission does not believe that highly technical form eligibility tests are appropriate for legislative action. Instead, the Commission intends to propose this change in the near future, and Commission staff has commenced preparation of the rulemaking proposal.

K. Section 315 -- Church Employee Pension Plans

Section 315 of S. 1815 would exempt from most federal securities regulation any church employee pension plan described in section 414(e) of the Internal Revenue Code of 1986 (the "Code") if, under the plan, no part of the assets may be diverted to purposes other than the exclusive benefit of employees.

Specifically, S. 1815 would: (1) except church employee pension plans ("Church Plans") from the registration, reporting and other regulatory requirements of the Investment Company Act; (2) exempt interests in Church Plans from registration under the Securities Act; and (3) exempt churches, church pension boards, and their internal personnel from registration as investment advisers under the Investment Advisers Act.⁷⁰ The proposed amendments also would exempt from federal securities regulation any company or account that is established by a person eligible to establish a Church Plan under section 414(e) of the Code, if substantially all of its activities relate to managing the assets of, or providing benefits under, exempt Church Plans. In addition, Section 315 would include within the definition of exempted securities under the Exchange Act securities issued by, or interests in, Church Plans. As a result, *any person* (including securities professionals) effecting transactions in securities issued by, or interests in, Church Plans would be exempt from the requirements of the Exchange Act. S. 1815 also specifically provides that church plans, as well as the trustees, directors, officers, employees or volunteers for such plans, would not be deemed broker-dealers under the Exchange Act if their only securities activities are on behalf of such plans and if no commission or other transaction-related compensation is received.⁷¹

Commission Recommendation. The Commission generally supports the exemptions for Church Plans and their related persons, but has certain reservations.

These exemptions provide relief only to Church Plans the assets of which must be used exclusively for the benefit of plan participants and beneficiaries. The proposed exemptions are similar, in most respects, to the exemptions already afforded to governmental

plans described in section 414(d) of the Code.⁷² The Commission objects to the proposed exemption from Exchange Act registration for interests in Church Plans, however, because it is unduly broad.

The amendments other than the Exchange Act exemption for securities issued by Church Plans appear to be narrowly drafted and to contain provisions designed to protect plan participants and beneficiaries. The requirement that "substantially all" of the activities of an exempt company or account be related to the Church Plan or its administration ensures that the exemption would be available only to a limited number of entities. Church Plans covered by the amendments must meet eligibility requirements under section 414(e) of the Code and must be administered for the exclusive benefit of participants and beneficiaries. Entities relying on these exemptions, therefore, will be unable to use assets for any other purpose without losing the availability of the exemptions. Further, while the proposed amendments would exempt from Investment Advisers Act registration Church Plans and their trustees, directors, officers, employees or volunteers who provide advice exclusively to such plans, the anti-fraud provisions of the Investment Advisers Act would continue to apply to such persons.⁷³

With respect to the Exchange Act provisions, the Commission supports the proposed exemption from broker-dealer regulation for securities activities on behalf of Church Plans, provided no transaction-based compensation is received by the Plan, or person associated with the Plan. In addition, treating the securities issued by, or interests in, Church Plans as exempted securities would be appropriate with respect to those Exchange Act provisions that apply to Church Plans and to the directors, officers, and employees of such Plans. We do not, however, believe that securities professionals engaged in the business of selling the securities issued by, or interests in, Church Plans should be exempt from the requirements of the Exchange Act. Accordingly, the Commission recommends that Church Plans only be treated as exempted securities for purposes of those provisions of the Exchange Act that directly affect those Plans and the persons associated with such Plans.

The Commission also is proposing one change to S. 1815 so that it can better monitor compliance with the new exemptions. To enable the Commission to identify entities relying on the exemptions, the Commission proposes that it be given rulemaking authority to adopt a form to be filed by entities relying on the new exemptions notifying the Commission of such reliance.⁷⁴

L. Section 316 – Promoting Global Preeminence of American Securities Markets

Section 316 expresses the sense of the Congress concerning the increasing internationalization of the securities markets and the related importance of establishing a high-quality comprehensive set of generally accepted international accounting standards that could be used in such offerings. The Section particularly notes that such standards would greatly facilitate international financing activities and, most significantly, would enhance the

ability of foreign issuers to access and list in United States markets. This Section expresses the sense that, in addition to the efforts made to date to respond to this growing internationalization, the Commission should enhance its vigorous support for the development of such accounting standards as soon as practicable. Finally, this Section requests the Commission to report within one year from the date of enactment of S. 1815 on the progress in the development of such standards and the outlook for successful completion of a set of standards that would be acceptable to the Commission for offerings and listings by foreign issuers in United States markets.

Commission Recommendation. The Commission agrees with the sense of Congress on this point and is prepared to submit the specified progress report.

As stated in the Commission's April 11, 1996 press release, the Commission supports the objective of the International Accounting Standards Committee ("IASC") to develop, as expeditiously as possible, accounting standards that could be used for preparing financial statements used in cross-border offerings. The IASC has announced a plan to accelerate its developmental efforts with a view toward completion of the requisite core set of standards by March 1998. The Commission believes there are three key elements to this program and the Commission's acceptance of its results:

- The standards must include a core set of accounting pronouncements that constitutes a comprehensive, generally accepted basis of accounting;
- The standards must be of high quality -- they must result in comparability and transparency, and they must provide for full disclosure; and
- The standards must be rigorously interpreted and applied.

The Commission is committed to working with its securities regulatory colleagues, through the International Organization of Securities Commissions, and with the IASC to provide the necessary input to achieve the goal of establishing a comprehensive set of international accounting standards. To facilitate this process on an expedited basis the Commission is devoting additional resources to the international accounting program. Notably, the Commission recently engaged Arthur R. Wyatt, Ph.D, CPA, as an expert consultant in the Office of the Chief Accountant. Professor Wyatt, a recognized expert on international accounting standards, has held many important posts, including past Chairman of the IASC, former member of the Financial Accounting Standards Board, past president of the American Accounting Association, and past member and Chairman of the Accounting Standards Executive Committee of the American Institute of Certified Public Accountants. Professor Wyatt will act as a senior policy adviser to the Commission's Chief Accountant for the Commission's initiatives involving the development of international accounting standards.

As noted above, under the IASC's accelerated work program it is hoped that the core set of standards will be completed by March 1998. Although the standards are not expected

to be completed within one year of the date of enactment of the Act, the Commission will be able to provide a report on the progress of this effort within that timetable.

ENDNOTES

1. See Testimony of Arthur Levitt, Chairman, U.S. Securities & Exchange Commission, Concerning the Commission's Authorization Request for Fiscal Year 1997, Hearing Before the Subcomm. on Telecommunications and Finance of the House Comm. on Commerce (Feb. 28, 1996); Testimony of Richard C. Breeden, Chairman, U.S. Securities and Exchange Commission, *Reauthorizations for the Securities and Exchange Commission 1992-94, Hearing Before the Subcomm. on Securities of the Senate Comm. Banking, Housing, and Urban Affairs* (July 25, 1991).
2. Section 103 of S. 1815 (adding new Section 203A to the Investment Advisers Act).
3. The Commission acknowledges that there are other ways to address this problem. See, e.g., S. 2266, The Investment Adviser Oversight Act of 1992, 102d Cong., 2d Sess. (1992) (legislation to increase the resources available to the Commission to conduct adviser examinations through modest fees on advisers to contribute to the cost of their regulation); S. 1410, The Investment Adviser Self-Regulation Act, 101st Cong., 1st Sess. (1989) (legislation to provide for an investment adviser SRO).
4. This figure excludes the \$3.5 trillion of investment company assets, which the Commission oversees under its investment company examination program.
5. Section 103 of S. 1815 (adding new Section 203A(c) to the Investment Advisers Act).
6. Section 103 of S. 1815 (adding new Section 203A(d) to the Investment Advisers Act).
7. The Commission notes that a Constitutional issue regarding state sovereignty may be raised by this provision. Although the law in this area is not clear, recent Supreme Court caselaw indicates that the Federal government may not require a state to adopt a specific regulatory program (although Congress may require a state to choose between adopting such an approach or having state law preempted). See *New York v. U.S.*, 112 S.Ct. 2408 (1992).
8. Section 105 of S. 1815 (amending section 203(e) of the Investment Advisers Act).
9. See H.R. REP. NO. 1382, 91st Cong., 2nd Sess. 10-11, 23-35 (1970); U.S. SECURITIES AND EXCHANGE COMMISSION, REPORT ON THE PUBLIC POLICY IMPLICATIONS OF INVESTMENT COMPANY GROWTH, H.R. REP. NO. 2337, 89th Cong., 2d Sess. 316-322 (1966) at 320 ("PPI REPORT"). As originally enacted in 1940, section 12(d)(1) contained certain prohibitions on fund of fund arrangements. The 1970 amendments provided that, subject to limited exceptions, a fund may not acquire more than 3% of another fund's voting stock, and may not invest more than 5% of its assets in any one fund. In addition, a fund's investments in all other funds may not exceed, on an aggregate basis, more than 10% of its assets. See sections 12(d)(1)(A)-(C) of the Investment Company Act, 15 U.S.C. § 80a-12(d)(1)(A)-(C).

10. Two funds of funds that commenced operations in 1985 and 1989, respectively, for example, have aggregate assets of approximately \$7.2 billion and approximately 400,000 aggregate shareholder accounts. See *T. Rowe Price Spectrum Fund, Inc.*, Investment Company Act Release No. 17198 (Oct. 31, 1989) (notice); Investment Company Act Release No. 17242 (Nov. 29, 1989) (order); *Vanguard Star Fund*, Investment Company Act Release No. 14153 (Sept. 12, 1984) (notice); Investment Company Act Release No. 14361 (Feb. 7, 1985) (order). The popularity of these funds of funds appears to be part of a broader trend in which investors are increasingly interested in arrangements designed to facilitate allocation of an investor's assets among certain categories of investments. Other asset allocation mechanisms offered today are wrap accounts and mutual fund wrap accounts. In a wrap fee program, the client typically is provided with portfolio management, execution of transactions, asset allocation, and administrative services for a single fee based on assets under management. Mutual fund wrap fee programs provide similar services, but the client account is invested only in mutual funds.
11. See, e.g., *Qualivest Funds*, Investment Company Act Release No. 21874 (Apr. 5, 1996) (notice); Investment Company Act Release No. 21933 (May 1, 1996) (order); *Twentieth Century Blended Portfolios*, Investment Company Act Release No. 21813 (Mar. 11, 1996) (notice); Investment Company Act Release No. 21875 (Apr. 8, 1996) (order).
12. S. 1815 would define a "group of investment companies" as any two or more mutual funds or unit investment trusts ("UITs") that hold themselves out to investors as related companies for purposes of investment and investor services. UITs are unmanaged investment companies (with no boards of directors) that invest in a fixed portfolio of securities and, like mutual funds, issue redeemable securities. See section 4(2) of the Investment Company Act, 15 U.S.C. § 80a-4(2).
13. Section 12(d)(1)(E)(iii)(aa) of the Investment Company Act. This provision also allows feeder funds, as an alternative to pass-through voting, to vote their shares in the master fund in the same proportion as the votes cast by the other feeder funds ("echo voting").
14. See, e.g., PPI REPORT, *supra* note 9, at 316-322 (discussing the dangers created when control is exercised by a fund holding company).
15. See, e.g., H.R. REP. NO. 1382, 91st Cong., 2d Sess. 23-24 (1970).
16. Because feeder funds that register with the Commission have agreed in their registration statements to provide pass-through voting for their shareholders, the legislation would not impose any new requirements.
17. See rule 24f-2(c) under the Investment Company Act, 17 CFR § 270.24f-2(c).

18. See rule 24f-2(b)(2) under the Investment Company Act, 17 CFR § 270.24f-2(b)(2). Among other consequences, shareholders of the fund may have rescission rights against the fund under the Securities Act. See section 12 of the Securities Act, 15 U.S.C. § 77l.
19. Dudley H. Ladd, *Why It's Time to Change the Advertising and Newsletter Rules*, 1995 MUTUAL FUNDS AND INVESTMENT MANAGEMENT CONFERENCE IV-B-11 (Federal Bar Assoc. and CCH Inc., 1995).
20. The advertising prospectus also would be subject to the summary suspension procedures under section 10(b) of the Securities Act, 15 U.S.C. § 77j(b), permitting the Commission to take prompt action to prevent the use or distribution of materially false or misleading advertisements. The Commission also could require advertising prospectuses to comply with the same standards for calculating performance information included in current advertisements. See rule 482 under the Securities Act, 17 C.F.R. 230.482.
21. 15 U.S.C. §§ 80a-26, -27. Periodic payment plans are a rare form of investment company today, but were common – and a source of serious abuses – before 1940.
22. Section 205 of S. 1815 (amending sections 26 and 27 of the Investment Company Act, respectively). In connection with the exemption, new Section 26(e)(2)(B) would codify certain provisions of Commission rules that permit an insurance company rather than a bank to maintain custody of separate account assets without a trust indenture. New Section 27(i)(2) also would preserve the current requirement that variable contracts be redeemable securities.
23. New Section 26(e)(2) of the Investment Company Act.
24. See section 35(d) of the Investment Company Act, 15 U.S.C. § 80a-34(d).
25. The judicial enforcement provision in current section 35(d) would be eliminated since the Commission could use the cease and desist authority in section 9(f) of the Act, 15 U.S.C. § 80a-9(f), and the general enforcement authority in section 42(d) of the Act, 15 U.S.C. § 80a-41(d), to enforce the prohibition on the use of a misleading fund name.
26. See Arthur Levitt, Chairman, U.S. Securities and Exchange Commission, *From Security to Self-Reliance: American Investors in the 1990s* (remarks at the Investment Company Institute General Membership Conference) (May 22, 1996).
27. Investment Company Act § 3(c)(1), 15 U.S.C. § 80a-3(c)(1).
28. The requirement to "look through" certain corporate shareholders to their underlying investors currently applies when a corporate shareholder acquires 10% of a section

3(c)(1) fund's securities and also has invested 10% of its assets in one or more section 3(c)(1) funds.

29. This approach is consistent with other federal securities law provisions that are based, in part, on the financial sophistication of investors. See section 4(6) of the Securities Act, 15 U.S.C. § 77d (accredited investors), rule 144A under the Securities Act, 17 CFR § 230.144A (qualified institutional buyers), Regulation D under the Securities Act, 17 CFR § 230.501 *et seq.* (accredited investors), and rule 205-3 under the Investment Advisers Act, 17 CFR § 275.205-3 (sophisticated clients).

Section 207(a) of S. 1815 would allow an existing section 3(c)(1) fund to be "grandfathered" into a new qualified purchaser pool provided the section 3(c)(1) fund gives its investors an opportunity, prior to the conversion, to redeem their interests in the fund. To prevent section 3(c)(1) funds from circumventing this requirement, Section 207(b) of S. 1815 would prohibit a section 3(c)(1) fund from investing in a qualified purchaser pool unless the fund's beneficial owners have consented to the fund's treatment as a qualified purchaser. To clarify that a section 3(c)(1) fund and a qualified purchaser pool under common management would not run afoul of the Commission's "integration" doctrine, Section 207(a) of S. 1815 provides that the two pools would not be treated as a single issuer. The Commission staff has applied the integration doctrine to determine whether two ostensibly different section 3(c)(1) funds operated by the same adviser should be considered a single fund (with more than 100 investors and therefore not excepted from the Investment Company Act) based on such factors as the funds' investment objectives, portfolio, and risk/return characteristics, and investors eligible to invest in the funds. See, e.g., Thomas S. Harman and Monica L. Parry, *Integration and Attribution Issues Affecting Hedge Funds*, 28 REV. OF SEC. AND COMMOD. REG. 215 (Dec. 6, 1995).

30. Since *all* pool participants would have to be highly sophisticated, whenever an institutional purchaser (e.g., an investment adviser) invests on behalf of another person (e.g., an individual client or an investment partnership) that person would also have to meet the qualified purchaser thresholds. The new provision also provides that a person who receives shares in a qualified purchaser pool as a gift, bequest, or by transfer caused by an involuntary event, would be deemed a qualified purchaser, subject to Commission rules, regulations, and orders.
31. The Commission understands that the thresholds are designed to be an indicia of the purchaser's sophistication with respect to investing in securities, particularly through a pooled management vehicle. Consistent with this understanding, the Commission anticipates defining investments to include securities that are held for investment (as opposed to, for example, securities that represent controlling ownership in a family business), as well as other financial assets.

32. Under a proposal recommended by the Commission and introduced in both Houses of Congress in 1992, the Commission would have had sole responsibility to specify, by rule, those persons eligible to invest in qualified purchaser pools. See The Small Business Incentive Act of 1992, S. 2518, 102d Cong., 2d Sess. (1992); H.R. 4938, 102d Cong., 2d Sess. (1992).

Section 207(d) of S. 1815 also directs the Commission to prescribe rules permitting participation in section 3(c)(1) funds and qualified purchaser pools by the employees of the fund or its affiliated persons.

33. New Section 2(a)(51)(B) of the Investment Company Act. The Commission could use its rulemaking authority, for example, to determine when securities under the discretionary management of a subsidiary could be considered those of the parent, or the circumstances under which the partners of an investment partnership would not meet the qualified purchaser thresholds.
34. The \$10 million and \$100 million thresholds, based on securities ownership (see note 31, *supra*, and accompanying text) were contained in The Small Business Incentive Act of 1993, S. 479, 103d Cong., 1st Sess. (1993) and The Small Business Incentive Act of 1994, H.R. 4858, 103d Cong., 2d Sess. (1994). According to the Senate report, the \$10 million and \$100 million eligibility thresholds were included, in part, in response to concerns expressed by the Investment Company Institute regarding participation in the new pools by unsophisticated investors. S. REP. NO. 166, 103d Cong., 1st Sess. 8-9 (1993).
35. As a recent report of the American Bar Association's Task Force on Hedge Funds ("ABA Task Force") noted, "There have been a number of proposals to define the level of financial sophistication which renders governmental regulation unnecessary . . . there are no absolute numerical standards for this purpose." Committee on Federal Regulation of Securities Task Force on Hedge Funds, *Report on Section 3(c)(1) of the Investment Company Act of 1940 and Proposals to Create an Exception for Qualified Purchasers*, 51 BUS. LAW. 773, 788 ("ABA Task Force Report").
36. See DIVISION OF INVESTMENT MANAGEMENT, U.S. SECURITIES AND EXCHANGE COMMISSION, *PROTECTING INVESTORS: A HALF CENTURY OF INVESTMENT COMPANY REGULATION* (1992) at 111-114 (suggesting that given the many risks to investors of committing assets to managed pools, the level of sophistication should be very high). See also *ABA Task Force Report*, *supra* note 35 at 789.
37. As the ABA Task Force noted, "It is the Commission, as the agency charged with the administration of the federal securities laws, that has the expertise to respond in a timely manner to changing investment and market conditions. Indeed, the Commission has traditionally used its exemptive and rulemaking authority under the federal securities laws cautiously." *ABA Task Force Report*, *supra* note 35 at 790.

38. Section 207(b) of S. 1815 (creating new Sections 2(a)(51)(A)(ii) and (iii) of the Investment Company Act).
39. 15 U.S.C. § 80b-5(a)(1).
40. H.R. REP. NO. 2639, 76th Cong., 2d Sess. 29 (1940). Performance fees in use at the time typically were designed to reward an adviser, above and beyond its customary fee, for good performance, without penalizing it for poor performance. Congress concluded that performance fees encouraged advisers to speculate unduly because they had everything to gain and little to lose.
41. Rules 205-1 and 205-2 under the Investment Advisers Act, 17 CFR 275.205-1, -2 (defining certain terms for purposes of computing a fulcrum fee). A fulcrum fee is computed based on the asset value of a fund or account under management averaged over a specified period, with proportionate increases and decreases based on the fund's or account's performance relative to an appropriate securities index.
42. Investment Advisers Act Release No. 996 (Nov. 14, 1985) (adopting rule 205-3).
43. These advisers would remain subject to the Investment Advisers Act's anti-fraud provisions with respect to these clients and thus would be prohibited from entering into performance fee arrangements that involve overreaching or are abusive.
44. The new exemption would become section 6(a)(5) of the Investment Company Act.
45. 15 U.S.C. § 77b(15).
46. Up to 20% of the company's securities could be sold to non-residents. This would provide flexibility for "spill-over" sales when, for example, an offering takes place in a metropolitan area that overlaps several states.
47. 15 U.S.C. § 80a-6(d)(1).
48. Unlike the economic, business, and industrial development companies described above whose activities relate to a particular state, these funds may invest in businesses throughout the United States.
49. Investment Company Act § 2(a)(46), 15 U.S.C. § 80a-2(a)(46).
50. Investment Company Act § 2(a)(48), 15 U.S.C. § 80a-2(a)(48).
51. Investment Company Act § 55(a), 15 U.S.C. § 80a-54(a).
52. Investment Company Act § 61(a)(2), 15 U.S.C. § 80a-60(a)(2).
53. Investment Company Act § 64(b), 15 U.S.C. § 80a-63(b).

54. A closed-end fund is an investment company that does not issue redeemable securities whose shares are traded on an exchange or other secondary market.
55. BDCs operate in accordance with specific provisions added to the Investment Company Act in 1980. SMALL BUSINESS INVESTMENT INCENTIVE ACT OF 1980, Pub. L. No. 96-477, 94 Stat. 2275 (codified in various sections of 15 U.S.C.).
56. Investment Company Act § 2(a)(48), 15 U.S.C. § 80a-2(a)(48).
57. While the Commission supports these provisions of S. 1815, the Commission remains concerned about the number of deficiencies under the Investment Company Act that have been detected by the staff in the course of its examinations of BDCs. *See, e.g., SEC v. Fluid Corp. and George T. Slaughter*, Litigation Release No. 12,661 (Oct. 9, 1990); *SEC v. Power Securities Corp.*, Litigation Release No. 12,605 (Sept. 6, 1990); *SEC v. Corporate Capital Resources, Inc.*, Litigation Release Nos. 13,460 and 13,751 (Dec. 7, 1992 and Aug. 11, 1993); *SEC v. Viruage Group, Inc.*, Litigation Release No. 13,994 (Mar. 7, 1994), and related administrative proceedings. Some of these deficiencies have resulted in the institution of enforcement proceedings against BDCs. Notably, however, the violations have involved provisions of the Investment Company Act that S. 1815 does not propose to amend.
58. *See, e.g.,* Investment Company Act rule 57b-1, 17 C.F.R. § 270.56b-1 (permitting BDCs to engage in principal transactions with controlled portfolio companies); Investment Company Act § 63(2), 15 U.S.C. § 80a-62(2) (permitting BDCs to issue their securities at a price below net asset value under certain conditions); Investment Company Act §§ 57(n), 61(a)(3)(B), 15 U.S.C. §§ 80a-56(n), -60(a)(3)(B) (permitting BDCs to establish profit-sharing plans for their directors, officers, and employees).
59. *See* S. REP. NO. 958, 96th Cong., 2d Sess. 4-5 (1980).
60. These numbers are derived from the minimum listing requirements for the National Association of Securities Dealers Automated Quotations System. Sections 1(c)(2) and 1(c)(3) of Part II to Schedule D of the National Association of Securities Dealers By-laws.
61. Investment Company Act § 55(a), 15 U.S.C. § 80a-54(a).
62. Investment Company Act § 55(a), 15 U.S.C. § 80a-54(a).
63. This preemption provision as drafted does not appear to include securities "senior to" the listed securities, although both the current state exemptions and the comparable provision in H.R. 3005 do cover such senior securities. Moreover, the preservation of filing fees in paragraph (d) of the section specifically carves out fees for listed securities and securities senior to the listed securities. The Commission assumes that

securities senior to listed securities were intended to be covered and suggests that the language be revised to make this clear.

In addition, the Commission notes that the preemption for listed securities would not apply to the specified problematic offerings (such as partnerships), even if the securities are listed. Such securities generally are exempt from state registration if listed, and are preempted (again, if listed) by H.R. 3005.

64. The Commission notes that as drafted this provision would cover only offers and sales to qualified purchasers in transactions registered under the Securities Act. The provision states that these transactions would be covered by paragraph (a), which provides preemption only for registered offerings. The Commission assumes that the provision is intended to cover both registered and exempt offerings and suggests that this language be clarified.
65. Additionally, the Commission notes that unlike H.R. 3005, S. 1815 provides preemption for investment company securities and "listed" securities only if the securities are registered under the Securities Act. The Committee may want to consider extending these provisions to transactions in such securities that are exempt from registration under the Securities Act.
66. Notably, both the Investment Company Act (section 6(c)) and the Investment Advisers Act (section 206A) provide the Commission with similar grants of broad exemptive authority. Similarly, Section 309 also would serve to clarify issues that have been raised as to the scope of the exemptive authority granted to the Commission in the Private Securities Litigation Reform Act. That Act clearly provided the Commission with additional exemptive authority under both the Securities Act and the Exchange Act. The precise boundaries of the exemptive authority contained therein have been questioned by some, and it therefore is appropriate for Congress to clarify this issue by unambiguously providing the Commission with grants of broad exemptive authority under both the Securities Act and the Exchange Act.
67. A number of provisions of the Exchange Act already provide the Commission exemptive authority. For example, Section 12(h) of the Exchange Act currently grants the Commission authority to exempt in whole or in part any issuer or class of issuers from the registration provisions of Section 12(g) of that Act. Similarly, a number of other provisions in the Exchange Act provide the Commission with specific exemptive authority in defined circumstances, see Sections 17(h)(4) and 15(a)(2) of the Exchange Act.
68. The Department of the Treasury has authority under section 15C of the Exchange Act to regulate government securities broker-dealers. It should be made clear that the broad grant of exemptive authority to the Commission in new Section 36 of the Exchange Act is not intended to extend to section 15C of the Exchange Act or to the definitions in sections 3(a)(42) through (45) as utilized in those sections.

69. In this regard, the Commission notes that the concept of "privatization" raises a number of complex legal and practical issues, ranging from issues related to security and liability (e.g., for the custody and accuracy of the corporate filings) to issues related to the recovery of private sector costs, fees, profits, and public access.
70. This exemption would apply only to the Church Plan and its internal personnel and would not be available to any third party who may provide investment advice to Church Plans.
71. These new exemptions would be added as Section 3(c)(14) of the Investment Company Act, Section 3(a)(13) of the Securities Act, Sections 3(a)(12)(A)(vi) and 3(f) of the Exchange Act, and as a new subsection of 203(b) of the Advisers Act.
72. Section 3(c)(11) of the Investment Company Act, 15 U.S.C. § 80a-3(c)(11), provides an exception from the definition of investment company for any governmental plan described in section 3(a)(2)(C) of the Securities Act, 15 U.S.C. § 77c(a)(2)(C). Section 3(a)(2)(C) of the Securities Act, 15 U.S.C. § 77c(a)(2)(C), exempts securities issued by a governmental plan as described in section 414(d) of the Code, from the registration provisions of that Act, if the governmental plan has been established for the exclusive benefit of plan participants and beneficiaries. There is a similar exemption under the Exchange Act for securities issued by governmental plans. See Section 3(a)(12)(C) of the Exchange Act, 15 U.S.C. § 77c(a)(12)(C).
73. In the event that assets are misappropriated or used for the employer's own purposes, the exclusive benefit rule would be violated and the staff could institute enforcement action to remedy such abuses. Moreover, if any person providing investment advice to a church plan defrauds plan participants, the Commission could enforce the antifraud provisions of the Advisers Act against that person.
74. While the Commission does not object to the provisions of the bill that would exempt Church Plans from federal securities regulation, we note that S. 1815 also provides for the preemption of all state securities regulation of such Plans, interests therein, and Plan personnel. The Commission is not familiar with the precise role played by the states in the regulation of Church Plans and recommends that the Committee consult with state regulators on this issue.