Investment Management Regulation

Our Investment Management Division regulates investment companies (which include mutual funds) and investment advisers under two companion statutes, the Investment Company Act of 1940 and the Investment Advisers Act of 1940. The Division also administers the Public Utility Holding Company Act of 1935. The Division's goal is to minimize financial risks to investors from fraud, self-dealing, and misleading or incomplete disclosure.

What We Did

- Completed implementation of improvements to the mutual fund disclosure form that the Commission adopted in 1998 as part of its continuing efforts to help investors make more informed investment decisions and to minimize prospectus disclosure common to all funds.

- Tightened the rule governing personal trading by investment company personnel and continued the Commission's commitment to improve investors' confidence in the market by addressing the appearance of conflicts of interest and self-dealing.

- Proposed a set of rule amendments designed to enhance the independence and effectiveness of fund boards.

- Continued implementing provisions of the National Securities Markets Improvement Act of 1996 (NSMIA) and issued no-action and interpretative letters addressing numerous changes in the investment company and investment advisory industries.

Significant Investment Company Act Developments

Rulemaking

Independent Directors

The Commission proposed new rules and rule amendments designed to enhance the independence and effectiveness of investment company (fund) directors. The rule proposals are intended to strengthen independent director's hands in dealing with fund management, reinforce their independence, and reaffirm the important role that they play in protecting fund investors and providing greater information about their actions and independence. The proposed rule amendments would, for funds relying on any of ten commonly used exemptive rules, require that: (1) independent directors constitute at least a majority of the board of directors; (2) independent directors select and nominate other independent directors; and (3) any legal counsel for the independent directors be an independent legal counsel. In addition, the proposals would exempt funds with independent audit committees from the requirement that shareholders ratify a fund's auditor.

The Commission also proposed rule amendments that would require funds to provide enhanced disclosure relating to their directors. Under the proposal, funds would be required to disclose basic information about: (1) the identity and business experience of each director; (2) the aggregate dollar amount of a director's holdings in the fund complex; (3) directors' potential conflicts of interest; and (4) information relating to the board's role in governing fund operations.

Personal Securities Activities of Fund Personnel

The Commission adopted amendments to rule 17j-1 under the Investment Company Act.[73] Rule 17j-1 addresses conflicts of interest that arise from personal trading activities of fund personnel. The amendments: (1) increase fund board oversight of the codes of ethics of funds, their investment advisers and principal underwriters; (2) improve the way in which fund personnel report personal securities holdings; and (3) require certain fund personnel (including portfolio managers) to obtain prior approval for investments in initial public offerings and certain limited offerings. Related amendments require funds to provide information in their registration statements about the policies of the fund, its investment adviser, and principal underwriter concerning personal investment activities.

Offers and Sales of Securities to Canadian Retirement Accounts

The Commission proposed two new rules and amendments to an existing rule that are designed to enable Canadian investors who reside or are temporarily present in the United States to hold and manage their investments in certain Canadian tax-deferred retirement accounts.[74] Proposed rule 237 under the Securities Act of 1933, proposed rule 7d-2 under the Investment Company Act, and proposed amendments to rule 12g3-2 under the Securities Exchange Act of 1934 together would permit securities of foreign investment companies and other foreign issuers to be offered and sold to those Canadian accounts without the securities or the investment companies being registered under U.S. securities laws. The rules would not, however, affect the applicability of the anti-fraud provisions of U.S. securities laws.

Foreign Custody Arrangements

The Commission proposed new rule 17f-7 under the Investment Company Act and amendments to rule 17f-5 concerning the foreign custody of investment company assets.[75] The proposals are designed to provide a workable framework under which an investment company can protect its assets while maintaining them with a foreign securities depository.

Repurchase Agreements

The Commission proposed new rule 5b-3 to codify and update staff positions that have permitted investment companies to "look through" certain repurchase agreements to the securities collateralizing those agreements for various purposes under the Investment Company Act.[76] The proposed rule would provide similar "look through" treatment for investments in municipal bonds, the repayment of which is fully funded by escrowed U.S. government securities. In addition, the Commission proposed amendments to rule 12d3-1, the rule that provides an exemption from the prohibition in section 12(d)(3) of the Investment Company Act on acquiring an interest in a broker-dealer or a bank engaged in a securities-related business. The proposed amendments would make rule 12d3-1 available for repurchase agreements that do not meet the conditions for "look through" treatment. Finally, the Commission proposed certain conforming amendments to rule 2a-7, the rule governing money market funds.

Deregistration of Certain Registered Funds

The Commission proposed and adopted amendments to Form N-8F and rule 8f-1, the form and rule that govern the deregistration of certain investment companies.[77] The amendments simplify and reorganize Form N-8F and expand the circumstances in which investment companies may use the form. The Commission also amended Regulation S-T to require that investment companies file Form N-8F on the SEC's Electronic Data Gathering, Analysis and Retrieval system (EDGAR). In 1999, the SEC began receiving applications from investment companies to deregister on EDGAR, and almost 80 percent of all applicants that received deregistration orders filed their applications on EDGAR.

Exemptive Orders

The Commission issued 269 exemptive orders to investment companies (other than insurance company separate accounts) seeking relief from various provisions of the Investment Company Act. Approximately 10 percent of these exemptive orders concerned mergers involving investment advisory firms or funds. The Commission also issued 60 exemptive orders to investment companies that are insurance company separate accounts.

Some of the significant developments with regard to exemptive orders in 1999 are discussed below.

Unaffiliated Funds of Funds

NSMIA expressly authorized the Commission to exempt fund of funds arrangements from the restrictions of the Investment Company Act to the extent the exemption is consistent with the public interest and the protection of investors. The Commission issued an order permitting a fund of funds arrangement involving fund investments in unaffiliated funds, subject to conditions designed to address investor protection concerns.[78]

Equity-Based Compensation for Closed-End Fund Managers

The Commission issued an order permitting a closed-end fund to provide its employees and the employees of its wholly-owned investment adviser with equity-based compensation such as stock options and stock appreciation rights.[79] The order contained conditions designed to address investor protection concerns, including the dilution of shareholder interests.

Status Issues under the Investment Company Act

The Commission issued several orders addressing the status of various types of companies under the Investment Company Act.[80] The orders generally provide relief from regulation as an investment company under the Investment Company Act.

Interpretive and No-Action Letters and Interpretive Releases

The Division's Office of Chief Counsel, which handles most requests for guidance directed to the Investment Management Division, responded to 956 formal and informal requests for guidance during 1999. In addition, other offices in the Division provided formal and informal guidance during 1999. Some of the most significant interpretive and no-action letters and interpretive releases are discussed below.

Independent Directors

The Commission issued an interpretive release expressing its views on:

- relationships that might disqualify a fund director from serving as an independent director of the fund;

- whether actions taken by fund directors in their capacities as directors would be “joint transactions” that require prior Commission approval;

- the circumstances in which funds may advance legal fees to directors; and

- the circumstances in which funds may compensate their directors with fund shares.[81]

The release also provides the Commission’s views on its role in disputes between independent directors and fund management.

Private Investment Companies

The staff addressed various issues relating to private investment companies under sections 2(a)(51)(A), 3(c)(1), and 3(c)(7) of the Investment Company Act, and rules 2a51-1, 2a51-3, 3c-5 and 3c-6 thereunder, including:

- who may qualify as a “knowledgeable employee”;

- the treatment of trusts and individual retirement accounts under certain of these provisions; and

- involuntary transfers of securities issued by private investment companies.[82]

Depositary Receipts Programs

The staff stated that it would not recommend enforcement action under section 7 of the Investment Company Act if a depositary receipts program is implemented without registering the underlying trust as an investment company under the Investment Company Act, subject to a number of representations. The depositary receipts program is intended to allow an investor to:

- hold a single, exchange-listed receipt representing the investor's beneficial ownership of certain securities held by the trust in a depositary capacity;

- maintain an ownership interest in each of the deposited securities represented by the receipt;

- exchange that receipt for each of the deposited securities; and

- trade the receipt at a lower cost than the cost of trading each of the deposited securities separately.[83]

Reorganization of Investment Advisers

The staff concluded that a trust formed to allow stockholders to retain the economic benefits of stock ownership, while transferring their voting rights to the trustee, would qualify as a "voting trust" for purposes of section 3(c)(12) of the Investment Company Act. The staff also agreed that a reorganization that results in a voting trust owning more than 25 percent of the voting securities of the parent of an investment adviser would not result in an assignment of an advisory contract when neither the trust nor its trustee would have beneficial ownership of, or voting discretion over, the shares held in the trust. The staff declined to address whether the ability of the board of the adviser's parent company to instruct the trustee how to vote the shares on certain matters would result in an actual change in control or management of the adviser.[84]

Records Substantiating Adviser Advertised Performance

The staff confirmed that copies of published materials listing the net asset values of an offshore fund could form the basis for performance information under section 204 of the Investment Advisers Act and rule 204-2(a)(16) thereunder, provided that the net asset values were accumulated contemporaneously with the management of the fund.[85] In addition, the staff confirmed that worksheets generated by an entity other than an adviser, subsequent to the management of the account, could demonstrate the calculation of performance information under the rule, provided that the worksheets were supported, in turn, by records that form the basis of the performance information.

Concentration Policies

The staff agreed that a fund may implement a concentration policy, consistent with Section 8(b)(1) of the Investment Company Act, that would permit it to invest more than 25 percent of its total assets in the securities of an industry when, among other things:

- the fund's principal objective is to invest primarily in equity securities of companies included in an independent and widely recognized index;

- the industry must represent more than 20 percent of that index before the fund may invest more than 25 percent of its total assets in the industry; and

- the fund invests no more than 35 percent of its total assets in the industry.[86]

Past Specific Recommendations

The staff stated that it would not recommend enforcement action under section 206(4) of the Investment Advisers Act and rule 206(4)-1(a)(2) thereunder if an investment adviser distributed reports to existing and prospective advisory clients that discuss some, but not all, of the adviser's investment decisions for the preceding quarter. In taking this position, the staff relied particularly on the adviser's representations that:

- it would use objective, non-performance based criteria to select the securities discussed;

- it would use the same criteria for each quarter for each category of investments;

- the reports would not discuss the profits or losses on any of the securities; and

- the adviser would keep certain enumerated records.[87]

Termination Fees

The staff provided interpretive guidance under section 206 of the Investment Advisers Act concerning an investment adviser's proposal to require its client to pay a fee upon termination of the advisory relationship for services previously rendered to the client. The staff concluded that the adviser could assess the fee upon the termination of the advisory contract consistent with section 206 as long as adequate disclosure is provided.[88]

Margin Credit and Short Sales

The staff agreed that an investment adviser that extends margin credit and facilitates short sales of securities in connection with providing clients with prime brokerage services would not be engaged in the purchase or sale of securities within the meaning of section 206(3) of the Investment Advisers Act.[89]

Board Role in Fund Investments in Repurchase Agreements

The staff stated that it would not recommend enforcement action under section 12(d)(3) of the Investment Company Act if a fund engages in repurchase agreements with a bank or broker-dealer and the fund's investment adviser, rather than the fund's board, assumes primary responsibility for monitoring and evaluating the fund's use of repurchase agreements. The staff also clarified that a fund, or its custodian, may maintain fund assets with the fund's transfer agent or a bank in the manner described in previous no-action letters under section 17(f) of the Investment Company Act without obtaining annual board review of the depository arrangements, provided that the board has approved each arrangement initially and approves any subsequent changes thereto.[90]

Disclosure

Implementation of Mutual Fund Disclosure Initiatives

In 1999, most mutual funds revised their prospectuses to comply with the revisions to Form N-1A, the mutual fund registration form, and the plain English initiative adopted by the Commission in 1998. Mutual funds filed post-effective amendments for 13,352 portfolios in 1999.[91] The staff reviewed 97 percent of these filings.

The staff reviewed 87 percent of the 2,256 new portfolios filed with the SEC, including 95 percent of the newly filed open-end (mutual fund) and closed-end portfolios. The staff also reviewed 93 percent of the 778 proxy statements filed, 63 percent of the 305 profiles filed, and 100 percent of the 234 insurance contract filings.

Section 13(f)(1) Reports

Institutional investment managers file Forms 13F to report certain equity holdings of accounts over which they exercise investment discretion (accounts with a fair market value of at least $100 million). The Commission estimates that approximately 2,000 managers are subject to this filing requirement. The information contained in the filings is used by the Commission, investors, and issuers in determining institutional investor holdings of an issuer.

Because of public interest in these filings, the Commission adopted rule amendments to require electronic filing of these reports on EDGAR.[92] The Commission's action affords these reports the same degree of public availability as other electronic filings made with the SEC.

Significant Investment Advisers Act Developments

Rulemaking

Political Contributions by Investment Advisers

The Commission proposed new rule 206(4)-5, and related amendments to rule 204-2, to address pay-to-play in the investment adviser industry. The new rule would prohibit an investment adviser from providing advisory services for compensation to a government client for two years after the adviser, any of its partners, executive officers, solicitors or any political action committee controlled by the adviser, makes a political contribution to certain elected officials or candidates. The prohibition would apply to all investment advisers that are not prohibited from SEC registration, but would not apply to certain *de minimis* contributions of $250 or less. The proposed rule also prohibits advisers and their executives, partners, and solicitors from soliciting contributions for an official of a government client to which the adviser is providing advisory services. SEC registered advisers that have government clients would be required to maintain certain records of political contributions under the proposed rule.[93]

Ohio Investment Advisers

The Commission adopted new rule 203A-6 under the Investment Advisers Act to provide a transition process for investment advisers subject to a new Ohio investment adviser statute. Under the rule, new Ohio advisers ineligible for SEC registration would register with the Ohio Division of Securities. Smaller Ohio advisers registered with the SEC will switch over to registration with the Ohio Division of Securities during the transition period. These advisers must withdraw their SEC registration by March 30, 2000.[94]

Delegation of Authority to Cancel Registration of Certain Investment Advisers

The Commission amended its rules to delegate to the Director of the Division of Investment Management authority to cancel the registration of any investment adviser that is not eligible for SEC registration.[95] This amendment updates the staff's delegated authority to reflect recent amendments to the Investment Advisers Act, and is intended to conserve SEC resources by permitting the staff to cancel, when appropriate, the registration of investment advisers that are not eligible to be registered with the SEC.

Significant Public Utility Holding Company Act Developments

Developments in Holding Company Regulation

As a result of the ongoing trend toward consolidation, the Commission considered a number of proposed utility combinations. Registered holding companies also continued to demonstrate an interest in nonutility activities, both in the United States and abroad. The complexity of applications and requests for interpretive advice continued to increase. The Commission expects these trends to continue in 2000, as the restructuring of the industry continues.

Registered Holding Companies

As of September 30, 1999, there were 19 public holding companies registered under the Holding Company Act. The registered systems were comprised of 107 public utility subsidiaries, 70 exempt wholesale generators, 216 foreign utility companies, 606 nonutility subsidiaries, and 110 inactive subsidiaries, for a total of 1,128 companies and systems with utility operations in 31 states. These holding company systems had aggregate assets of approximately $197 billion, and operating revenues of approximately $77 billion for the period ended September 30, 1999.

Financing Authorizations

The Commission authorized registered holding company systems to issue approximately $13.3 billion of securities, a decrease of approximately 32 percent from last year. The decrease is largely due to the Commission’s policy of approving comprehensive system finance plans for longer periods of time. The total financing authorizations included $6.6 billion for investments in exempt wholesale generators and foreign utility companies.

Examinations

The staff conducted examinations of three service companies, three parent holding companies, and nine special purpose corporations. The examinations focused on the methods of allocating costs of services and goods shared by associate companies, internal controls, cost determination procedures, accounting and billing policies, and quarterly and annual reports of the registered holding company systems. By identifying misallocated expenses and inefficiencies through the examination process, the SEC's activities resulted in savings to consumers of approximately $18.4 million.

Applications and Interpretations

The Commission issued various orders under the Holding Company Act. Some of the more significant orders are described below.

NIPSCO Industries, Inc.

The Commission authorized NIPSCO Industries, Inc. (NIPSCO), an Indiana intrastate exempt electric and gas public utility holding company, to acquire Bay State Gas Company (Bay State), a Massachusetts gas public utility holding company exempt from registration under section 3(a)(2).[96] Bay State and its gas utility subsidiary, Northern Utilities, Inc., provide gas utility services in several New England states. In approving the acquisition, the Commission found that the NIPSCO and Bay State electric and gas operations constituted a single integrated utility system because, among other things, the merger of the gas departments of NIPSCO and the Bay State system would permit coordination of gas supply. In granting the exemption, the Commission determined that, taking into account Bay State's out-of-state operations, NIPSCO's utility operations would continue to be predominantly intrastate in character.

AES Corporation

The Commission granted AES Corporation (AES), a Virginia-based electric power generation and energy distribution company not previously subject to the Holding Company Act, an exemption under section 3(a)(5) following its acquisition of CILCORP, Inc. (CILCORP), an Illinois intrastate exempt electric and gas public utility holding company.[97] AES operates primarily in foreign markets, but also has significant domestic operations not subject to the Act. In granting the exemption, the Commission determined that the utility operations that AES would acquire were small in both a relative sense (*i.e.*, not material) and an absolute sense. The Commission further determined that it was no longer necessary to limit the section 3(a)(5) exemption to U.S. holding companies whose operations are essentially foreign to achieve the policy objectives of the Act. The Commission found that granting the exemption to AES was consistent with the underlying rationale of the exemption and the Act's legislative history, including subsequent amendments to the Act.

Sempra Energy

The Commission authorized Sempra Energy (Sempra), a California electric and gas public utility holding company exempt from registration under section 3(a)(1) of the Holding Company Act, to acquire a 90.1 percent interest in Frontier Energy, LLC (Frontier), a North Carolina partnership organized to construct, own and operate a gas utility distribution system in North Carolina.[98] The Commission found that Frontier's gas operations would be integrated with those of Sempra because, among other things, Frontier would realize substantial economies as a result of its access to a nonutility subsidiary of Sempra that would provide certain gas portfolio management services to Frontier. The Commission determined that Sempra and Frontier would be confined in their operations "to a single area or region," because they would "deriv[e] natural gas from a common source of supply."

Entergy Corporation

Entergy Corporation (Entergy), a registered holding company, and its utility and nonutility subsidiary companies were authorized to amend their service agreements to modify the pricing of services provided by the regulated utility companies to their nonutility associates.[99] The Commission approved a pricing provision that included the fully allocated cost of the service, including labor and overhead, plus 5 percent. The variations in pricing were necessary in order to implement certain provisions of settlement agreements between Entergy and its state regulators. The settlement agreements were designed to protect consumers from the risks of Entergy's nonutility activities.