Investment Management Regulation

The Investment Management Division regulates investment companies (which include mutual funds, closed-end funds, and unit investment trusts) 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

- Introduced a new on-line electronic registration and filing system for investment advisers.
- Adopted rules requiring investment companies and investment advisers to safeguard personal financial information, and to disclose their privacy policies to customers.
- Proposed amendments that would require mutual funds to disclose standardized after-tax returns for 1-, 5-, and 10-year periods to help investors understand the magnitude of tax costs and compare the impact of taxes on the performance of different funds.
- Adopted and amended rules permitting the delivery of a single prospectus and single copy of a shareholder report to two or more investors sharing the same address.

- Adopted and amended rules enabling Canadian investors living in the United States to purchase and sell in Canadian tax-deferred retirement accounts securities not registered for sale in the United States.

Significant Investment Company Act Developments

Rulemaking

- *After-Tax Returns.* A mutual fund's trading practices and investment strategies affect the amount of taxes that investors must pay on fund profits. To help investors understand the magnitude of tax costs and compare the impact of taxes on the performance of different funds, the Commission proposed rule amendments that would require mutual funds to disclose standardized after-tax returns for 1-, 5-, and 10-year periods.[37] After-tax returns, which would accompany before-tax returns, would be presented in two ways: (1) returns after taxes on fund distributions only; and (2) returns after taxes on fund distributions and a redemption of fund shares.

- *Householding*. The Commission adopted a new rule under the Securities Act, and amended rules under the Exchange Act and the Investment Company Act, to allow mutual funds to deliver a single prospectus and single copy of a shareholder report to two or more investors sharing the same address.[38]

- *Offers and Sales of Securities to Canadian Retirement Accounts*. The Commission adopted and amended rules permitting Canadian investors who reside or are temporarily present in the United States to manage their investments in Canadian tax-deferred retirement accounts.[39] The Commission adopted new rule 237 under the Securities Act and new rule 7d-2 under the Investment Company Act, and amended rule 12g3-2 under the Exchange Act, to permit foreign investment companies and other foreign issuers to offer and sell securities to those Canadian investors' tax-deferred retirement accounts without registering the securities or the investment companies under United States securities laws. The rules do not, however, affect the applicability of the anti-fraud provisions of the United States securities laws.

- *Foreign Custody Arrangements*. The Commission adopted new rule 17f-7 under the Investment Company Act, and amended rule 17f-5 under the Investment Company Act, concerning the foreign custody of investment company assets.[40] The new rule and amendments permit mutual funds to keep fund assets in eligible foreign securities depositories that are regulated by a foreign financial regulatory authority and that comply with the rule's standards for security, recordkeeping, and reporting.

- *Interim Investment Advisory Contracts*. The Commission amended rule 15a-4 under the Investment Company Act, the rule that

permits an investment adviser to an investment company to serve for a short period of time under an interim contract that shareholders have not approved.[41] The amendments: (1) clarify the timing of the board of directors' approval of the interim contract; (2) allow an adviser to serve under an interim contract after a merger or other business combination involving the adviser or a controlling person of the adviser; and (3) lengthen the maximum duration of the interim contract from 120 days to 150 days.

- *Electronic Signatures Act*. The Commission adopted an interim rule under the Securities Act to exempt from the consumer consent requirements of the Electronic Signatures in Global and National Commerce Act (Electronic Signatures Act) prospectuses of registered investment companies that are used for the sole purpose of permitting supplemental sales literature to be provided to prospective investors.[42] This rule implements a provision of the Electronic Signatures Act, which directs the Commission to provide such an exemption. Consistent with Commission interpretations of existing law, the rule permits a registered investment company to provide its prospectus and supplemental sales literature on its web site or by other electronic means without first obtaining investor consent to the electronic format of the prospectus**.**

- *Significant Investor Privacy Developments.* The Commission adopted Regulation S-P,

privacy rules promulgated under the Gramm-Leach-Bliley Act of 1999.[43] Regulation S-P implemented the requirements of the Gramm-Leach-Bliley Act with respect to, among others, SEC-registered investment advisers and investment companies, which are financial institutions subject to the SEC's jurisdiction under that Act, by requiring them to:

- o disclose their privacy policies to customers initially, then annually, during the customer relationship;

- o provide a method for consumers and customers to opt out of disclosure of information to third parties; and

- o adopt policies and procedures to protect the confidentiality and integrity of nonpublic personal information.

Exemptive Orders

The Commission issued 300 exemptive orders to investment companies (other than insurance company separate accounts) seeking relief from various provisions of the Investment Company Act. The Commission also issued 64 exemptive orders to investment companies that are insurance company separate accounts.

Some of the significant exemptive orders that the Commission issued in fiscal 2000 are discussed below.

- *Exchange-Traded Funds.* The Commission issued several orders permitting open-end investment companies to operate as exchange-traded funds.[44] Two of these

orders were the first to grant prospective relief for certain exchange-traded funds that applicants may offer in the future.[45] The Commission also issued an order permitting an open-end investment company to issue an exchange-traded class of shares.[46]

- *Internet Holding Company.* The Commission issued an order declaring that an Internet holding company was not an investment company under the Investment Company Act.[47]

- *Unaffiliated Fund-of-Funds*. The National Securities Markets Improvement Act of 1996 (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 unit investment trust to invest in unaffiliated mutual funds, subject to conditions designed to address investor protection concerns.[48] The Commission also issued an order upon an application from an "underlying fund" to permit unaffiliated funds-of-funds to acquire shares of the underlying fund.[49]

- *Foreign Investment Company*. The Commission issued an order permitting a South African closed-end investment company, registered under section 7(d) of the Investment Company Act, to maintain its assets with a central securities depository in South Africa.[50]

- *Shareholder Approval of Subadvisory Contracts*. The Commission issued an order permitting an open-end investment company that operates as a "multi-manager" fund to enter into, and materially amend, subadvisory agreements with sub-advisers that are wholly owned subsidiaries of the adviser and with sub-advisers that are not affiliated with the adviser.[51] The order did not require shareholder approval of the new or amended subadvisory agreements.

- *Managerial Strategic Investment Company*. The Commission issued an order permitting an applicant to operate as a managerial strategic investment company (MSIC). As an MSIC, the applicant will provide a source of long-term financial support and managerial assistance to public companies seeking to improve their competitiveness.[52]

Interpretive and No-Action Letters, Interpretive Releases, and Staff Legal Bulletins

Some of the most significant Investment Company Act guidance that the Division issued in 2000 is discussed below.

- *Valuation and Redemption*. The staff provided interpretive guidance to mutual funds and their directors concerning the valuation of portfolio securities, and suspensions of redemptions of fund shares. The guidance included:

- when and how funds must fair value price their portfolio securities;

- factors that funds should consider when fair value pricing their portfolio securities;

- how fund boards may discharge their obligations to fair value price a fund's portfolio securities in good faith; and

- when funds are permitted to suspend redemptions.[53]

- *Distribution Information*. The staff stated that a mutual fund could provide information about actual and estimated distributions to shareholders, via the fund's automated telephone system, consistent with rule 482 under the Securities Act, even though the information did not meet certain requirements of the rule that apply to the presentation of performance data.[54]

- *Reporting Requirements for Independent Directors*. The staff stated that it would not recommend enforcement action under section 17(j) of the Investment Company Act and rule 17j-1 if, for purposes of the personal trading reporting requirements of rule 17j-1, certain directors of an investment adviser to an investment company are treated in the same manner as are the directors of the investment company who are not "interested persons" of that company.[55]

- *Collective Investment Trusts*. The staff stated that a collective investment trust that

consists of certain separate funds is "maintained by a bank" for purposes of an exclusion from the definition of "investment company" under the Investment Company Act if the bank exercises "substantial investment responsibility" with respect to each of those funds. The staff also stated that a bank is exercising "substantial investment responsibility" if the bank exercises all or substantially all of the investment responsibility required in managing the trust.[56]

- *Finance Companies.* The staff stated that it would not recommend enforcement action under section 7 of the Investment Company Act if a finance company did not register as an investment company and treated its operating company subsidiary as a majority-owned subsidiary for purposes of the 40 percent test in section 3(a)(1)(C) of the Act, even though the voting power to elect a majority of the board of directors of the operating company was held, not by the finance company, but by the owners of the trust units issued by the finance company.[57]

  The staff also stated that it would not recommend enforcement action under section 7 of the Investment Company Act if a finance company did not register as an investment company under the Act in reliance on rule 3a-5 where the finance company's securities were controlled, but not owned, by either the finance company's parent, or companies controlled by the parent. The finance company would be formed solely to provide financing for the parent or companies controlled by the

parent and, with the exception of having only one class of securities that the parent or companies controlled by the parent, at least initially, would not "own," the finance company either would meet all of the conditions in rule 3a-5, or would have the same characteristics as finance subsidiaries organized as business trusts with respect to which the staff previously agreed not to recommend enforcement action to the Commission.[58]

- *In-Kind Redemptions*. The staff stated that it would not recommend enforcement action under section 17(a) of the Investment Company Act if, in limited circumstances, a fund satisfies a redemption request from an affiliated person by means of an in-kind distribution of portfolio securities, without obtaining an order from the Commission under section 17(b) of the Act.[59]

- *Shareholder Approval of Reduction of Closed-End Fund Advisory Fee*. The staff stated that it would not recommend enforcement under section 15(a) of the Investment Company Act if an investment adviser to a closed-end fund serves under an advisory contract after implementing a permanent reduction in the amount of compensation paid under the contract, without seeking and obtaining shareholder approval for the change in compensation.[60]

- *Bunched Orders for Privately Placed Securities*. The staff provided interpretive guidance regarding, and no-action relief under, section 17(d) of the Investment

Company Act, and rule 17d-1, to an investment adviser that proposed to aggregate orders, on behalf of itself and funds and private accounts for which it served as adviser, for the purchase and sale of private placement securities for which the adviser negotiated no term other than price.[61] In a subsequent letter, the staff clarified that its prior guidance and relief did not address aggregated transactions in which a fund's investment adviser: (1) does not participate or have a material pecuniary interest in a party that does participate; but (2) negotiates the terms of the private placement securities on behalf of the fund and other participants in the transaction.[62]

- *Multiple Interim Advisory Contracts*. The staff stated that it would not recommend enforcement action under section 15(a) of the Investment Company Act if an investment adviser serves, for a total of no more than 150 days, under certain interim investment advisory contracts that were not approved by the funds' shareholders. The original contracts terminated due to their assignment, which occurred in connection with a change in control of the adviser. Control of the adviser changed two additional times, resulting in the assignment and termination of the first and second set of interim advisory contracts with the funds.[63]

- *Presentation of Fund Performance*. The staff stated that it would not recommend enforcement action under section 5(b) of

the Securities Act, section 34(b) of the Investment Company Act, or section 206 of the Investment Advisers Act if a fund spins off one of its classes of shares into a newly created fund and the newly created fund includes the performance information of the spun-off class as part of its standardized performance information, provided that, among other things, the new fund is a continuation of the spun-off class.[64]

- *Index Fund Investments in Securities-Related Issuers*. The staff stated that it would not recommend enforcement action under section 12(d)(3) of the Investment Company Act if, under certain circumstances, a fund that has an investment objective of matching the investment performance of an unaffiliated, broad-based, securities market index, or an index that is based on sector classifications of such an index, invests more than 5 percent of its total assets in securities issued by certain financial services companies.[65]

Significant Investment Advisers Act Developments

Rulemaking

- *Electronic Filing for Investment Advisers.* The Commission replaced the paper-based system for SEC investment adviser registration with the Investment Adviser

Registration Depository (IARD), a one-stop, Internet-based registration system for investment advisers. The initiative involved the proposal and adoption of several new and amended rules and forms under the Investment Advisers Act to accommodate the new IARD, reflecting changes effected by NSMIA and other recent legislation, and making other improvements. SEC-registered advisers were required to transition to the IARD system during January – April 2001.[66]

- *Investment Adviser Disclosure.* The Commission proposed amendments to the disclosure brochure that SEC-registered investment advisers must provide to their clients. Under the proposed amendments, the brochure would be a narrative document, written in plain English, providing information about the advisory firm, its business practices, and its disciplinary history. Supplements to the brochure would disclose information, including disciplinary information, about advisory personnel.[67]

- *Broker-Dealer Exclusion.* The Commission proposed new rule 202(a)(11)-1 under the Investment Advisers Act to exclude certain broker-dealers, registered with the Commission under the Exchange Act, from the definition of "investment adviser" under the Investment Advisers Act. The proposed rule would exclude a broker-dealer that charges asset-based fees, provided the

broker-dealer does not have discretionary authority over an account and satisfies certain other conditions. The proposed rule also would exclude a broker-dealer that charges one commission rate for execution-only brokerage accounts and higher commission rates for full-service brokerage accounts. Under the current regulatory regime, these fee structures could result in the broker-dealer being an investment adviser under the Investment Advisers Act. The proposed rule also clarifies that if a broker-dealer is subject to the Investment Advisers Act, it is subject to the Act only with respect to its advisory clients.[68]

Interpretive and No-Action Letters, Interpretive Releases, and Staff Legal Bulletins

- *Records Substantiating Investment Adviser Advertisements*. The staff notified investment advisers that advertise their performance that they can facilitate examinations by the staff by maintaining: (1) records prepared by third parties (*e.g.*, custodial or brokerage statements) that confirm the accuracy of client account statements and other performance-related records maintained by the advisers pursuant to rule 204-2(a)(16) under the Investment Advisers Act; and (2) reports prepared by independent auditors that verify the advisers' advertised performance.[69]

- *Financial Advisors.* The Division issued a Staff Legal Bulletin providing guidance on the applicability of the Investment Advisers

Act to financial advisors to issuers of municipal securities. The staff clarified the circumstances under which financial advisors may be investment advisers under the Investment Advisers Act (*e.g.,* when their advice routinely goes beyond the structuring of bond offerings to the investment of temporarily idle bond proceeds in non-government securities). The staff also specified that financial advisors may provide specific advice to clients about investing bond proceeds in money market funds without being deemed investment advisers under certain circumstances.[70]

Significant Public Utility Holding Company Act Developments

Developments in Holding Company Regulation

The trend toward consolidation of utility company systems resulted in an increase in the number of proposed mergers and acquisitions considered by the Commission in 2000. The Commission approved 5 new registered holding companies in 2000. Also in 2000, foreign companies purchased domestic utility systems for the first time, and holding companies continued to invest in nonutility activities in the United States and abroad.

Registered Holding Companies

As of September 30, 2000, there were 23 public utility holding companies registered under the Holding Company Act. The registered systems were comprised of 186 public utility subsidiaries, 68 exempt wholesale generators, 354

foreign utility companies, 840 nonutility subsidiaries, and 244 inactive subsidiaries, for a total of 1,715 companies and systems with utility operations in 39 states. These holding company systems had aggregate assets of approximately $287 billion, and operating revenues of approximately $121 billion for the period ended September 30, 2000.

Financing Authorizations

The Commission authorized registered holding company systems to issue approximately $17.8 billion of securities, an increase of approximately 54 percent from last year. The total financing authorizations included $2.7 billion for investments in exempt wholesale generators and foreign utility companies.

Examinations

The staff conducted examinations of 2 service companies, 2 parent holding companies and 12 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 $9.7 million.

Orders

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

- *The National Grid Group plc*. The Commission authorized The National Grid Group plc (National Grid), a U.K. public limited company, to acquire New England

Electric System (NEES), a domestic registered holding company. In finding that the transaction satisfied the requirements of the Holding Company Act, the Commission evaluated several factors, including issues related to foreign acquisitions of United States utilities. Following the merger, National Grid and each of the intermediate holding companies formed to facilitate the merger registered as public utility holding companies under section 5 of the Holding Company Act.[71]

- *American Electric Power Company, Inc*. The Commission authorized American Electric Power Company, Inc. (AEP), a registered holding company, to acquire Central and South West Corporation (CSW), also a registered holding company. The Commission found physical interconnection and coordination of the combined system, in part, on the basis of a four-year 250-megawatt contract path providing east-to-west firm transmission service from AEP to CSW.[72]

Concept Release

The Commission issued a concept release seeking comment on various issues relating to foreign acquisitions of United States utilities.[73] Specifically, the Commission solicited comment on the impact of foreign ownership on effective Commission regulation, effective state regulation, investor protection, and consumer protection.

No-Action Letter

The staff issued a no-action letter to HSBC Holdings plc, a U.K. financial services holding company, and certain of its subsidiaries (collectively, HSBC Group). The members of HSBC Group collectively owned more than 10 percent of the common stock of National Grid and provided loans and services to National Grid in connection with the acquisition of NEES (see above). HSBC Group requested assurance that no member of the group would be regulated as a holding company under section 2(a)(7), or an affiliate under section 9(a)(2), of the Holding Company Act, provided that the HSBC Group adhered to certain voting limitations and other conditions and restrictions placed on its relationship with National Grid, NEES, and NEES' domestic subsidiaries.[74]