

Investment Management Regulation

Overview

“As is readily apparent, Chairman Donaldson has laid out an ambitious regulatory agenda in the investment management area. And it is a challenge we are committed to meeting.”

Paul Roye, Director
Division of Investment
Management

167 staff in the Division of Investment Management and 21 staff in the Office of Filings and Information Services:

- Regulated over 8,000 mutual funds with assets of \$7 trillion and almost 8,000 investment advisers with assets under management of about \$20 trillion.
- Developed 16 rules designed to improve disclosure to investors and strengthen and modernize the regulation of investment companies and investment advisers.
- Issued a report on the “Implications of the Growth of Hedge Funds.”

Key Results

Issue	Result
Sarbanes-Oxley Act of 2002	The Commission adopted rules tailored to mutual funds requiring CEO and CFO certification of shareholder reports, disclosure of codes of ethics, standards of professional conduct for attorneys, auditor independence, listing standards for audit committees, and disclosure of audit committee financial experts.

Issue	Result
Enhanced Fund Disclosure	The Commission approved rules requiring funds to disclose their proxy voting policies and voting records. Also, the Commission adopted rule amendments under which funds must present more balanced information in their advertisements, especially when discussing past performance. Finally, the Commission proposed amendments to substantially expand the disclosure contained in fund shareholder reports.
Fund and Adviser Operations	The Commission adopted rules under the USA PATRIOT Act requiring customer identification programs for mutual funds. New rule amendments will permit funds to conduct certain transactions with affiliates. The Commission proposed a rule requiring that funds and advisers have policies, procedures, and a designated officer all dedicated to ensuring compliance with the federal securities laws and regulations.
Hedge Funds	The staff concluded a comprehensive study on the implications for investors of the significant growth in hedge funds. This report provides an overview of the industry and recommends ways to improve hedge fund regulation and oversight.

Main Activities	Fiscal 2003	Fiscal 2002	% Change
New Portfolios Registered	2,536	2,110	+20%
Annual and Periodic Reports Reviewed	1,134*	0	--
Responses to Formal and Informal Requests for Guidance Completed	1,507	1,417	+6%
Requests for Exemptive Relief Completed	332	450	-26%
Rule Proposals Adopted by the Commission	16**	5	+220%

* The Sarbanes-Oxley Act requires the staff to review financial information contained in annual reports to shareholders at least once during a three-year period.

** Not including final action on one rule proposal from the Office of Public Utility Regulation.

Significant Developments Related to the Investment Company Act

Total assets managed by investment companies at the end of fiscal 2003 equaled \$7.3 trillion, an increase of almost 16% from a year earlier. Much of this growth can be attributed to rising stock markets, with leading indices recording increases of between 22% and 52% over the prior year. The \$7.3 trillion managed by investment companies is almost

double the amount on deposit at commercial banks and is essentially equal to the financial assets at commercial banks. Mutual funds are the largest segment of the investment company industry. Over 53 million U.S. households, 48% of the total, own mutual funds. Mutual funds account for approximately 21% of all retirement assets and 45% of all 401(k) assets.

Rulemaking

Implementation of the Sarbanes-Oxley Act

The Commission adopted a number of rules implementing the Sarbanes-Oxley Act with respect to registered investment companies. For example, the Commission adopted rules that require registered investment management companies to

file shareholder reports on new Form N-CSR, certified by their principal executive and financial officers.⁶⁶ Other rules covered provisions such as:

- Auditor independence requirements (Title II): This rule prohibits auditors from providing certain non-audit services; strengthens the requirements related

to conflict of interest standards, auditor partner rotation, and second partner reviews; and clarifies and enhances the relationship between the independent auditor and the audit committee.⁶⁷

- Requirements for listed companies' audit committees (Section 301): This rule directs national securities exchanges and national securities associations to prohibit the listing of any security that is not in compliance with certain audit committee requirements.⁶⁸
- Disclosure with respect to codes of ethics (Section 406): This rule requires a company to disclose whether it has adopted a code of ethics that applies to the company's principal executive officer and senior financial officers.⁶⁹
- Disclosure of audit committee financial experts (Section 407): This rule requires a company to disclose whether it has at least one "financial expert" serving on its audit committee, and if so, the name of the expert and whether the expert is independent of management.⁷⁰

Proxy Voting

The Commission adopted amendments that require management investment companies to disclose how they vote proxies relating to their portfolio securities.⁷¹ The amendments are designed to enable shareholders to

monitor investment companies' involvement in the governance of portfolio companies. They also require investment companies to disclose both the specific proxy votes they cast and the policies and procedures they use to determine how to vote the proxies.

Investment Company Advertising

The Commission adopted rule amendments that will encourage investment companies to convey more balanced information in their advertisements to prospective investors, particularly with respect to past performance.⁷² Among other things, the amendments require investment companies that advertise performance to provide investors via the Internet or a toll-free or collect phone number the fund performance figures for the most recent month-end. The amendments also eliminate the requirement that certain investment company advertisements contain only information for which the substance is included in the statutory prospectus.

Customer Identification Programs

The Commission, the U.S. Department of the Treasury, and other federal financial regulators adopted rules to protect the U.S. financial system from money laundering, terrorist financing activity, and fraud.⁷³ Specifically, the rules require financial institutions to: (1) make a reasonable attempt to verify the identity of any person seeking to open an account; (2) maintain records of the information used to verify the person's identity;

and (3) determine whether the person appears on any list of known or suspected terrorists or terrorist organizations.

Transactions of Investment Companies with Portfolio and Subadviser Affiliates

The Commission adopted a new rule and several rule amendments related to transactions between investment companies and their affiliates.⁷⁴ The Investment Company Act contains a number of provisions that prevent persons who may be in a position to take advantage of an investment company from entering into transactions or arrangements with the investment company. These include prohibitions on affiliated transactions and joint transactions with affiliated persons. The rule and amendments eliminate the need for funds to obtain individual exemptive orders in circumstances that do not raise investor protection concerns.

Research and Development Companies

The Commission proposed and adopted a new rule providing certain bona fide research and development companies with a nonexclusive safe harbor from the definition of an investment company.⁷⁵ The rule enables the companies to determine their status under the Investment Company Act without the need to seek Commission orders.

Compliance Program

The Commission proposed a new rule to ensure that all investment companies have effective internal compliance programs.⁷⁶ If adopted, the rule would require that investment companies adopt and implement policies and procedures designed to prevent violation of the federal securities laws, review the effectiveness of those policies and procedures annually, and designate a chief compliance officer. The Commission also requested comment on several other ways to involve the private sector in promoting compliance with federal securities laws.

Quarterly Portfolio Disclosure and Shareholder Reports

The Commission proposed a variety of amendments to improve investment companies' periodic disclosure of their portfolio investments and costs.⁷⁷ These amendments would require mutual funds to disclose in shareholder reports the expenses borne by shareholders. Management investment companies would have to file a complete schedule of portfolio holdings with the Commission on a quarterly basis, rather than semi-annually as currently required. Management investment companies could include a summary portfolio schedule in their shareholder reports in lieu of a complete schedule, as long as the complete schedule is available on request. Finally, shareholder reports would need to include a tabular or graphic presentation of the investment company's portfolio holdings by identifiable categories.

Exemptive Orders

The Commission issued 252 orders based on applications seeking relief from various provisions of the Investment Company Act. Some of the significant orders and related releases that the Commission issued in fiscal 2003 are discussed below.

- *Principal Protected Funds.* The Commission issued two orders allowing registered investment companies with a principal protection feature (that is, a feature designed to allow fund shareholders to obtain a return of at least their initial investment) to purchase the principal protection from their affiliates.⁷⁸
- *Exchange-Traded Funds.* The Commission issued five orders granting exemptive relief to permit exchange-traded funds (ETFs)

based on equity securities indices.⁷⁹ The Commission also issued an order permitting the introduction of additional ETFs based on fixed-income securities indices.⁸⁰ Finally, the Commission granted an exemptive order allowing registered investment companies to purchase shares of certain ETFs in excess of statutory limits.⁸¹

- *Foreign Investing.* The Commission issued an order exempting certain registered investment companies from various prohibitions on affiliated transactions, in order to facilitate the companies' investment in Indian securities.⁸² The exemption was intended in part to enable the funds to achieve certain tax efficiencies when they make such investments.

Interpretive and No-Action Letters

Of the 15 interpretive and no-action letters issued by the division's Office of the Chief Counsel, some of the most significant related to the Investment Company Act and are discussed below.

- *Investments in European Union Investment Companies.* The staff stated that closed-end investment companies organized in the United States may invest in investment companies organized in the European Union in excess of the limits set by the Investment Company Act.⁸³

- *Tuition Prepayment Plans.* The staff stated that it would not recommend enforcement action to the Commission under the Investment Company Act if a tuition prepayment plan did not register as an investment company. The plans offer prospective students the opportunity to lock in and prepay discounted rates at any participating private educational institution.⁸⁴
- *Exchange Offers.* The staff concluded that a registered mutual fund may make an exchange offer on a specified delayed

basis, so long as the offer is consistent with the Investment Company

Act and is fully and clearly disclosed in the fund's prospectus.⁸⁵

Other

The Commission issued the staff's report entitled "Implications of the Growth of Hedge Funds."⁸⁶ The report provides basic information about hedge funds, an overview of the federal securities laws and regulations that affect hedge fund operations and their advisers, the nature of hedge fund investment

strategies, and the functions of their service providers. In addition, the staff discusses its concerns with various aspects of hedge funds and their regulation and recommends a number of regulatory alternatives. The Commission is currently considering the staff's recommendations.

Significant Developments Related to the Investment Advisers Act

By the end of fiscal 2003, almost 8,000 investment advisers were registered with the Commission.

These advisers had assets under management of approximately \$20 trillion.

Rulemaking

Proxy Voting

As a companion to its mutual fund proxy voting rules, the Commission adopted a new rule that addresses proxy voting by investment advisers.⁸⁷ Under the new rule, an investment adviser that votes client securities must establish policies and procedures to ensure that it addresses conflicts of interest and votes in the client's best interest. The rule also requires the adviser to disclose information about these policies and procedures and ways that clients can obtain information on how their securities are voted.

Custody of Funds and Securities

The Commission adopted amendments to modernize

the rules governing advisers' custody of client funds and securities.⁸⁸ The amendments enhance the protections afforded to clients' assets and harmonize the custody rule with current custodial practices. The amended rule requires investment advisers to maintain clients' funds and securities with a qualified custodian such as a broker-dealer or bank. If the qualified custodian sends quarterly account statements directly to clients, the adviser no longer would need to prepare quarterly account statements nor undergo an annual surprise examination of the client funds and securities in its custody. The amendments also clarify when an investment adviser has custody and therefore must comply with the rule.

Compliance Program

The Commission proposed new rules and amendments to ensure that all investment advisers registered with the Commission have effective internal compliance programs.⁸⁹ If adopted, the proposal would require each investment adviser to adopt and implement policies and procedures reasonably designed to prevent violations of the Investment Advisers Act, review the effectiveness of those policies and procedures annually, and designate a chief compliance officer. The Commission also requested comment on several other ways

to involve the private sector in enhancing compliance with the federal securities laws.

Anti-Money Laundering Program

We assisted the U.S. Treasury with its proposed rule to require investment advisers to establish anti-money laundering programs.⁹⁰ Promulgated under the authority of the USA PATRIOT Act, the proposed rule would prescribe minimum requirements for advisers' anti-money laundering programs and would task the Commission with examining certain advisers for their compliance.

Interpretive and No-Action Letters

Among other actions in this area, the staff stated that it would not recommend enforcement action to the Commission if persons subject to certain disciplinary actions act as solicitors for registered

investment advisers under some limited circumstances. The staff also stated that it will no longer respond to related requests for no-action relief unless the requests present novel or unusual issues.⁹¹

Significant Developments Related to the Public Utility Holding Company Act (PUHCA)

During fiscal 2003, the Commission issued a number of orders in response to the continuing turmoil in the utility industry, particularly in the electricity trading and merchant generation markets. Mergers and other consolidations continued at a slow pace, largely as a result of market conditions and the pendency of comprehensive energy legislation in Congress. While utility holding company systems continued to show interest in investing in non-utility activities, holding

companies have substantially reduced their ownership of foreign utility assets. By the end of the year, 58 public utility holding companies comprising 28 public utility holding company systems were registered under PUHCA. The registered systems consisted of 150 public utility subsidiaries, 176 exempt wholesale generators, 114 foreign utility companies, 4,606 non-utility subsidiaries and 703 inactive subsidiaries, for a total of 5,749 companies and systems with utility operations in 44

	<p>states. These holding company systems had aggregate assets of approximately \$623 billion and operating revenues of</p>	<p>approximately \$103 billion for the six-month period ending June 30, 2003.</p>
<p>Financing Authorizations</p>	<p>The Commission authorized registered holding company systems to issue \$55 billion of securities, a decrease of 66% from last year. This</p>	<p>amount included \$24 billion for investments in exempt wholesale generators and foreign utility companies.</p>
<p>Examinations</p>	<p>We examined 6 service companies, 6 parent holding companies, and 56 non-utility companies. The examinations focused on the companies' internal controls, cost determination procedures, accounting and billing policies, methods of allocating costs of services and goods shared</p>	<p>by associate companies, and quarterly and annual reports of the registered holding company systems. By identifying inefficiencies and misallocated expenses, these examinations resulted in savings to consumers of approximately \$44.5 million.</p>
<p>Orders and Other Matters</p>	<p>We issued numerous orders under PUCHA. Some of the more significant orders are described below.</p> <ul style="list-style-type: none"> • <i>Allegheny Energy Inc.</i> The Commission issued orders involving Allegheny and its subsidiary, Allegheny Energy Supply Co. These companies experienced severe liquidity problems largely as a result of their decision in 2001 to expand into merchant generation and energy trading. The Commission authorized the companies to carry out various transactions even though their common equity ratios were below the ratio normally required of registered companies and their subsidiaries.⁹² • <i>Enron Corporation.</i> A public hearing was held on December 5, 2002 to determine whether Enron 	<p>satisfied the objective criteria for exemption under sections 3(a)(1), 3(a)(3), and 3(a)(5) of PUHCA. In February, the SEC's Chief Administrative Law Judge issued an initial decision denying Enron's applications.⁹³ Enron and others filed petitions for Commission review of the initial decision. This review is continuing.</p> <ul style="list-style-type: none"> • <i>Xcel Energy, Inc.</i> The Commission authorized Xcel to declare and pay dividends out of capital and unearned surplus in an aggregate amount not to exceed \$152 million. Xcel's request was conditioned on its common equity ratio being at least 30% of capitalization.⁹⁴ • <i>OPUR Online.</i> In August 2003, the Commission added a new component

to its website, www.sec.gov, that gives the public access to orders, pending applications, and notices. The website also contains

answers to frequently asked questions, information about registered holding companies, and a list of exempt holding companies.

Outlook for 2004

In 2004, we expect to undertake the following initiatives:

- Take a number of actions to address various trading abuses of mutual fund shares, such as late trading and market timing.
- Consider additional ways to bolster funds' and investment advisers' compliance policies and procedures to prevent violations of the federal securities laws.
- Enhance mutual fund fee and expense disclosure, by considering for adoption a number of rule proposals, including new shareholder report requirements that would enable investors to determine the amount of fees they paid on their fund investments and to compare fees paid in other funds.
- Improve prospectus disclosure of fund breakpoints and examine the disclosure of funds' portfolio transaction costs.
- Detail the information that should be reviewed and retained when fund boards consider contracts with investment advisers.