

# Investment Management Regulation

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*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.*

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## What We Did

- As part of the Commission's actions to implement the Sarbanes-Oxley Act of 2002, adopted a new rule requiring a mutual fund's principal executive and financial officers to certify the fund's reports on Form N-SAR; and to better implement the intent of the Act, proposed a new form that would be certified by the fund's principal executive and financial officers and would contain shareholder reports, the primary means by which funds provide financial statements to investors.
- With other federal financial regulators, proposed rules to implement the requirements of the USA PATRIOT Act. These rules to prevent money laundering and terrorist financing would require mutual funds to adopt procedures to verify their customers' identities.
- Proposed amendments requiring mutual funds to disclose their proxy votes and voting policies and procedures to enable shareholders to monitor their

funds' involvement in the governance of portfolio companies; and proposed rules requiring investment advisers to adopt written policies and procedures governing how they vote proxies for client securities.

- Proposed amendments to modernize the mutual fund advertising rules, designed to encourage fund advertisements to convey more balanced information to prospective investors, particularly with respect to past performance.
- Approved the first exchange-traded funds (ETFs) based on fixed-income indices, giving investors another option to invest in a basket of fixed-income securities. The Commission also issued a concept release seeking input on actively managed ETFs.
- Adopted new registration Form N-6 for variable life insurance policies.
- Adopted amendments providing greater flexibility for mutual funds to merge without obtaining an exemptive order from the Commission and proposed amendments to permit certain affiliated transactions involving sub-advisers and portfolio affiliates in circumstances under which investor protection would not be compromised.
- Proposed amendments to modernize custody rules for investment companies and investment advisers.

## **Significant Investment Company Act Developments**

Total assets managed by investment companies at the end of fiscal 2002 were \$6.7 trillion, approximately the same amount as a year earlier. A sharp decline in equity assets was offset by increases in fixed income and money market assets. During the fiscal year, stock prices continued to retreat from record highs set

in 2000, with the major stock indices recording declines of between 11 and 19 percent. The technology-oriented Nasdaq Composite index closed at 1,172.06 on September 30, 2002, down more than 75 percent from its March 10, 2000 peak of 5,048.62. Notwithstanding these declines, the \$6.7 trillion managed by investment companies remains almost double the \$3.7 trillion on deposit at commercial banks and roughly equals the \$6.8 trillion of financial assets at commercial banks. At the end of 2002, a total of 31,100 investment company portfolios were managed or sponsored by 995 investment company complexes. Open-end management investment companies, commonly known as mutual funds, are the largest segment of the investment company industry. Approximately 54 million U.S. households, representing 50 percent of total households, own mutual funds.

### Rulemaking

- *Chief Executive Office/Chief Financial Officer Certifications.* The Commission implemented section 302 of the Sarbanes-Oxley Act with respect to registered investment companies by adopting amendments requiring each registered investment company's principal executive and financial officers to certify the information contained in its reports on Form N-SAR, the form designated for registered investment companies to comply with their periodic reporting requirements under the Securities Exchange Act of 1934.<sup>72</sup> In addition, the Commission proposed amendments designed to better implement the intent of section 302 of the Sarbanes-Oxley Act with respect to investment companies, by requiring the principal executive and financial officers of registered management investment companies to certify a new Form N-CSR, which contains shareholder reports.<sup>73</sup>
- *Customer Identification Programs.* The Commission and other federal financial regulators, including the U.S. Department of the Treasury, proposed rules to implement section 326 of the USA PATRIOT Act, which directs the issuance of regulations requiring financial institutions to institute reasonable procedures for (1) verifying the identity of

any person seeking to open an account, to the extent reasonable and practicable; (2) maintaining records of the information used to verify the person's identity; and (3) determining whether the person appears on any list of known or suspected terrorists or terrorist organizations.<sup>74</sup> The proposed rules seek to protect the U.S. financial system from money laundering and terrorist financing activity. Additionally, the identity verification procedures required under the rules may serve to protect consumers against various forms of fraud, including identity theft.

- *Proxy Voting.* The Commission proposed amendments that would require mutual funds and other registered management investment companies to provide disclosure about how they vote proxies relating to portfolio securities they hold.<sup>75</sup> The proposals are designed to enable fund shareholders to monitor their funds' involvement in the governance activities of portfolio companies. The proposals would require registered management investment companies to file with the Commission and to make available to their shareholders the specific proxy votes that they cast in shareholder meetings of issuers of portfolio securities. Under the proposed amendments, registered management investment companies also would be required to disclose the policies and procedures that they use to determine how to vote proxies relating to portfolio securities.
- *Variable Life Insurance Registration Form.* The Commission adopted a new registration form, Form N-6, for variable life insurance policies.<sup>76</sup> The new form focuses prospectus disclosure on essential information that would assist an investor in deciding whether to invest in a particular variable life insurance policy. In particular, Form N-6 requires a uniform, tabular presentation of fees and charges in order to improve disclosure of the often complex charges associated with variable life insurance policies.

- *Mergers of Affiliated Investment Companies.* The Commission adopted amendments to rule 17a-8 under the Investment Company Act.<sup>77</sup> Rule 17a-8 allows affiliated registered investment companies to merge without obtaining a specific exemptive order from the Commission. The amendments expand the rule to permit a greater range of fund mergers consistent with the protection of fund investors.
- *Investment Company Advertising.* The Commission proposed rule amendments that are designed to encourage mutual fund advertisements to convey more balanced information to prospective investors, particularly with respect to past performance.<sup>78</sup> The proposed amendments would, among other things, require funds that advertise performance to make available returns that are current to the most recent month-end by a toll-free or collect telephone number. The proposals also implement a provision of the National Securities Markets Improvement Act of 1996 by eliminating the requirement in rule 482 under the Securities Act of 1933 that investment company advertisements under that rule contain only information the substance of which is included in the investment company's statutory prospectus.
- *Transactions of Investment Companies with Portfolio and Subadviser Affiliates.* The Commission proposed a new rule and several amendments governing exemptions for transactions between investment companies and their affiliated persons.<sup>79</sup> 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 would eliminate the need for funds to obtain individual exemptive orders in circumstances that are not likely to raise investor protection concerns.

- *Acquisition of Securities During the Existence of an Underwriting or Selling Syndicate.* The Commission adopted amendments to rule 10f-3, which allows a fund that has certain affiliations with an underwriting participant to purchase securities during an offering.<sup>80</sup> The amendments expand the exemption provided by the rule to permit a fund to purchase U.S. government securities (including securities issued by government-sponsored entities) in a syndicated offering.
- *Custody of Investment Company Assets with a Securities Depository.* The Commission proposed amendments to rule 17f-4 under the Investment Company Act.<sup>81</sup> The proposed amendments would permit additional types of organizations to operate as depositories under the rule, allow depositories to perform additional functions, and expand the types of investment companies that can rely on the rule.

## Exemptive Orders

The Commission issued 309 orders based on applications reviewed by the Office of Investment Company Regulation seeking relief from various provisions of the Investment Company Act. The Commission also issued 46 exemptive orders based on applications reviewed by the Office of Insurance Products.

Some of the significant orders and related releases that the Commission issued in fiscal 2002 are discussed below.

- *ETFs.* The Commission issued a concept release seeking comment on actively managed ETFs.<sup>82</sup> Comments received in response to this concept release are intended to inform the Commission's review of any future exemptive applications to introduce actively managed ETFs. The Commission also issued two orders permitting the first ETFs based on fixed income securities indices.<sup>83</sup> In addition, the Commission

issued an order to allow dealers to sell shares of certain existing and future ETFs in the secondary market without delivering a prospectus under certain circumstances.<sup>84</sup>

- *Closed-End Interval Fund.* The Commission issued an order permitting an exchange traded closed-end investment company to conduct periodic repurchase offers in compliance with rule 23c-3 under the Investment Company Act, but with additional flexibility to set the amount of each repurchase offer and the periodic intervals between repurchase offers, as well as to pay the proceeds in-kind.<sup>85</sup>
- *Affiliated Transactions.* The Commission issued an order permitting certain investment companies to engage in securities transactions involving a broker-dealer or a bank that is an affiliated person of an affiliated person of the investment companies.<sup>86</sup> The Commission also issued a statement concerning reimbursement of proxy solicitation expenses of an affiliated shareholder by registered investment companies under section 17(d) of the Investment Company Act and rule 17d-1.<sup>87</sup>
- *Status Under the Investment Company Act.* The Commission issued an order exempting a company from all provisions of the Investment Company Act for a period no longer than four years.<sup>88</sup> The Commission also issued an order exempting an escrow account from all provisions of the Investment Company Act except section 9 and sections 36 through 53.<sup>89</sup>
- *Relief for Arthur Andersen LLP Auditing Clients.* To minimize any potential disruptions that may have occurred as a result of the indictment of Arthur Andersen LLP, the Commission issued an order under the Investment Company Act and Investment Advisers Act that, among other things, provided for an extension of time in obtaining and filing financial statements and other reports from an independent accountant other than Arthur Andersen.<sup>90</sup> The order also

provided relief for investment company audit committees in selecting new independent auditors.

## Interpretive and No-Action Letters

Some of the most significant Investment Company Act guidance that the Division issued in 2002 is discussed below.

- *Status of Certain Legal Counsel to Independent Fund Directors as Non-Interested Persons.* The staff provided interpretive guidance to investment companies, stating that a person would not be an interested person, as defined in section 2(a)(19)(A)(iv) of the Investment Company Act, of a registered investment company solely because the person acts as legal counsel for the fund's independent directors. The staff further noted that a fund's payment of fund-related legal expenses of the independent directors' legal counsel would not, by itself, mean that such counsel is acting as the fund's legal counsel for purposes of that section.<sup>91</sup>
- *Internet-based Auction Program Offers Capital to Help Mutual Funds Meet Redemption Needs.* The staff issued a letter to a fund in which the staff agreed not to recommend enforcement action to the Commission under sections 18(f) or 22(d) of the Investment Company Act or rules 12b-1 or 22c-1 thereunder in connection with an Internet-based auction program. Specifically, the letter addressed instances in which a fund proposes to make capital available to certain open-end registered investment companies to help them meet their redemption needs.<sup>92</sup>
- *Reporting and Recordkeeping Requirements Relating to Certain Canadian Mutual Funds.* The staff agreed not to recommend enforcement action to the Commission under section 17(j) of the Investment Company Act and rule 17j-1 thereunder if access persons of a registered investment company do not report their personal transactions in and holdings of shares of certain Canadian mutual funds.



Similarly, the staff agreed not to recommend enforcement action to the Commission under section 204 of the Investment Advisers Act and rule 204-2(a)(12) if registered investment advisers do not make and keep records of advisory representatives' personal trading transactions in shares of certain Canadian mutual funds.<sup>93</sup>

- *Master and Feeder Funds.* The staff stated that it would not recommend enforcement action to the Commission under section 12(d)(1) of the Investment Company Act if a feeder fund engages in certain foreign currency hedging contracts in addition to investing in a master fund. Under the Investment Company Act, feeder funds generally are prohibited from holding any investment securities other than shares of the master fund.<sup>94</sup>
- *Private Investment Companies.* The staff stated that it would not recommend enforcement action to the Commission under section 7 of the Investment Company Act if a conduit does not register as an investment company under the Act. The conduit will privately offer its short-term paper in the United States while simultaneously publicly offering its short-term paper outside of the United States.<sup>95</sup>
- *Money Market Funds.* The staff stated that it would not recommend enforcement action to the Commission under sections 34(b) or 35(d) of the Investment Company Act or rule 22c-1 against funds that hold themselves out as money market funds in reliance on rule 2a-7 under the Act. Specifically, staff will not recommend action if such money market funds purchase certain preferred stock, provided that they otherwise comply with the conditions of rule 2a-7.<sup>96</sup>
- *Independent Directors.* The staff concluded that mutual funds can pay their independent directors' membership dues in a mutual fund directors organization, without violating the Investment Company Act's prohibitions against affiliated joint transactions. The mutual fund directors organization is a

non-profit corporation dedicated to improving fund governance by offering continuing education and outreach programs to fund directors.<sup>97</sup>

- *Affiliated Transactions.* The staff stated that it would not recommend enforcement action to the Commission under section 17(a) of the Investment Company Act with respect to certain issues raised in connection with the merger of two banking institutions. The letter permits one of the banking institutions, which is affiliated with certain funds, to sell its securities to, and purchase the other institution's securities from, the funds involved in the merger without obtaining an exemptive order from the Commission under the affiliated transaction prohibitions of the Investment Company Act.<sup>98</sup>
- *Funds Organized as Limited Partnerships.* The staff concluded that under certain circumstances the corporate general partner of a fund organized as a limited partnership, as well as the natural persons through which the general partner acts, would not be considered directors of the fund, as that term is defined in section 2(a)(12) of the Investment Company Act.<sup>99</sup>
- *Reimbursement of Proxy Expenses.* The staff stated that it would not recommend enforcement action to the Commission under section 17(d) of the Investment Company Act and rule 17d-1 if a fund reimburses an affiliated shareholder for the proxy solicitation expenses that he incurred in connection with the annual shareholder meeting at which he was elected an independent director of the fund.<sup>100</sup>
- *Securities Depositories.* The staff agreed that the Government Securities Clearing Corporation acts as a securities depository, as defined in rule 17f-4 under the Investment Company Act, in connection with its clearance and settlement of U.S. government securities through a mechanism that allows its member dealers to engage in

general collateral repurchase agreements with dealers that use different clearing banks.<sup>101</sup>

- *Independent Fund Counsel.* The staff provided guidance to fund directors regarding questions that have arisen concerning the independent legal counsel provision in the fund governance rule amendments that the Commission adopted in 2001. In particular, the staff provided guidance regarding a fund director's determination that certain legal counsel to the fund is independent.<sup>102</sup>

## Other

- *Fund Names--Frequently Asked Questions (FAQs).* The staff issued responses to FAQs about Investment Company Act rule 35d-1, which addresses certain broad categories of investment company names that are likely to mislead investors about an investment company's investments and risks. The staff's responses addressed the following topics: adoption of an 80 percent investment policy; application of the rule to tax-exempt funds; specific terms commonly used in fund names; notices to shareholders of changes in investment policies; and compliance dates.<sup>103</sup>
- *After-Tax Returns--FAQs.* The staff issued responses to FAQs about the Commission's mutual fund after-tax return rule amendments.<sup>104</sup> These amendments require mutual funds to disclose in their prospectuses after-tax returns based on standardized formulas. The amendments also require funds to include standardized after-tax returns in certain advertisements and sales materials.<sup>105</sup>
- *Electronic-Only Variable Annuity.* The Commission accelerated the effectiveness of a registration statement for an electronic-only variable annuity offered by the American Life Insurance Company of New York--the first product of its kind.<sup>106</sup> The annuity contract is offered and sold over the Internet. Before an investor may purchase the contract, he or

she must consent to electronic delivery of all documents relating to the contract. American Life will treat a contract owner's revocation of consent to electronic delivery as a surrender of the contract. In declaring the registration statement effective, the Commission stated that its decision to do so reflected the particular facts and circumstances of the registration statement.

## **Significant Investment Advisers Act Developments**

As of September 30, 2002, 7,700 investment advisers were registered with the Commission. These advisers had assets under management of approximately \$21 trillion.

### Rulemaking

- *Proxy Voting.* As a companion to its mutual fund proxy voting rule proposal, the Commission proposed new rules under the Investment Advisers Act that would address proxy voting by investment advisers.<sup>107</sup> The proposed rules would require an investment adviser that votes client securities to (1) establish proxy voting policies and procedures designed to ensure the adviser addresses material conflicts of interest that may arise between the adviser and its client and (2) vote proxies in the best interest of the client. The proposal would also require the adviser to disclose information about these policies and procedures and how clients may obtain information on how their proxies are voted.
- *Custody of Funds and Securities.* The Commission proposed amendments to modernize the Investment Advisers Act rule governing investment advisers' custody of client funds and securities.<sup>108</sup> The proposal is designed to harmonize the custody rule with current custodial practices and enhance the protections afforded to clients' assets. The proposed amendments would require an investment adviser with custody of client assets to maintain those assets with a

qualified custodian, such as a broker-dealer or bank. If the qualified custodian sends monthly account statements directly to the clients, the adviser would no longer be obligated to prepare and deliver quarterly account statements to the client or undergo an annual surprise examination of the client funds and securities in its custody. The proposed amendments would also clarify when an investment adviser has custody subjecting it to the rule's requirements.

- *Commission Registration of Investment Advisers Operating Through the Internet.* The Commission proposed a new rule that would exempt certain investment advisers that advise their clients through the Internet from the prohibition against Commission registration under the Investment Advisers Act.<sup>109</sup> The only Internet investment advisers that would be eligible for the exemption are those that advise substantially all of their clients through interactive websites. Clients of these advisers submit personal information on-line through the adviser's website and the adviser's computer-based application generates personalized investment advice that is communicated to the client through the website. The effect of the proposed exemption would be to permit these Internet investment advisers, whose clients can come from any state at any time, to register with the Commission rather than with multiple state securities authorities.

#### Interpretive and No-Action Letters

- *Performance Fees.* The staff stated that it would not recommend enforcement action to the Commission if a registered investment adviser operates under an agreement with a registered investment company that provides for a performance fee notwithstanding certain transfers of fund shares to persons to whom the investment adviser could not directly charge a performance fee.<sup>110</sup>
- *Information Provided Through Password-Protected Websites.* The staff stated that it would not recommend enforcement

action to the Commission under section 203(a) of the Investment Advisers Act if, under certain circumstances, unregistered investment advisers provide information about themselves to a website operator for inclusion on password-protected websites. The staff emphasized that the websites would be available exclusively to the institutional sales and trading desks of registered broker-dealers to streamline their communication with institutional investors for brokerage services and to fund managers to monitor their competition. The staff also emphasized that the website operator would implement procedures that would effectively prevent persons who may be seeking advisory services from gaining access to the websites.<sup>111</sup>

- *Investment Adviser Status.* The staff concluded that the National Football League Players Association would not be an investment adviser as defined in section 202(a)(11) of the Investment Advisers Act as a result of its operation of a program in which the Association provides its members with a list of financial advisers that have passed certain screening requirements established by the Association. The staff also stated that it would not recommend enforcement action to the Commission under section 206(4) of the Investment Advisers Act and rule 206(4)-3 against the Association and investment advisers participating in the Association's program if those investment advisers make cash payments to the Association and do not treat the Association as a solicitor.<sup>112</sup>

## **Significant Public Utility Holding Company Act Developments**

### Developments in Holding Company Regulation

The trend towards consolidation of utility company systems slowed but still resulted in an increase in the number of proposed mergers and acquisitions considered by the Commission in fiscal 2002. The Commission approved four new registered holding companies in fiscal 2002. In addition, utility holding company

systems continued to show interest in investments in nonutility activities on both domestic and foreign fronts.

### Registered Holding Companies

As of September 30, 2002, there were 64 public utility holding companies comprising 28 public utility holding company systems registered under the Holding Company Act. The registered systems were comprised of 132 public utility subsidiaries, 186 exempt wholesale generators, 114 foreign utility companies, 5,018 nonutility subsidiaries and 599 inactive subsidiaries, for a total of 6,113 companies and systems with utility operations in 44 states. These holding company systems had aggregate assets of approximately \$601 billion and operating revenues of approximately \$142 billion for the six-month period ending June 30, 2002.

### Financing Authorizations

The Commission authorized registered holding company systems to issue approximately \$163 billion of securities, an increase of approximately 107 percent from last year. The total financing authorizations included approximately \$102.5 billion for investments in exempt wholesale generators and foreign utility companies.

### Examinations

The staff conducted examinations of 6 service companies, 6 parent holding companies and 18 nonutility companies. 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 Commission's activities resulted in savings to consumers of approximately \$31.8 million.

## Orders

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

- *Relief for Arthur Andersen LLP Public Utility Clients.* The Commission issued an order to minimize any potential disruptions that may have occurred as a result of the indictment of Arthur Andersen LLP.<sup>113</sup> The order provided for an extension of time for registered public utility holding companies to obtain and file financial statements and other reports from an independent accountant other than Arthur Andersen.
- *Xcel Energy, Inc.* The Commission authorized Xcel Energy, Inc. (Xcel), a public utility holding company, to purchase the outstanding common stock of NRG Energy, Inc., a partially-owned nonutility subsidiary of Xcel, by means of a tender or exchange offer. The order also denied a request for a hearing.<sup>114</sup>
- *E.ON AG.* The Commission issued an order approving the application by E.ON AG (E.ON), a German corporation that was a utility holding company exempt by rule 5 under the Holding Company Act, to acquire Powergen plc, a British corporation that is a registered holding company, because of its ownership of Louisville Gas & Electric and Kentucky Utilities, two utility subsidiaries that operate primarily in Kentucky. The acquisition involved novel issues including,
  - permitting a registered holding company with foreign utility operations to retain ownership of a foreign water utility,
  - permitting E.ON to invest additional money in businesses that the Holding Company Act requires



them to divest in order to maximize the value at which those businesses will likely be sold,

- requiring a registered holding company to divest nonconforming companies within five years rather than the typical two or three years, and
  - permitting E.ON to invest in equity securities of third parties in an amount designed to allow it to meet future pension liabilities and nuclear decommissioning costs without making those investments through a separate entity.<sup>115</sup>
- *Reliant Energy, Incorporated.* The Commission authorized Reliant Energy, Incorporated (REI), a Texas corporation engaged in various electric, gas and nonutility businesses to restructure its operations. REI operated an electric utility in Texas through its HL&P division, owned a gas utility that, through three divisions, operated in Texas, Louisiana, Arkansas, Oklahoma, Mississippi and Minnesota, and owned an 83 percent interest in Reliant Resources, a merchant generation and energy trading company. Specifically, REI sought authority to spin-off its remaining stake in Reliant Resources to its existing shareholders, and reorganize its remaining utility operations. As a result of this reorganization, REI (now renamed CenterPoint Energy) was required to register under the Holding Company Act.<sup>116</sup>