Investment Management Industry News Summary - June 2002

JUNE 30, 2002

This Summary, which draws from a wide range of sources, endeavors to condense important investment management regulatory news of the preceding week into one, easily digestible source. This Summary is not intended as legal advice. Readers should not act upon information contained in this Summary without professional legal counsel. This Summary may be considered advertising under the rules of the Supreme Judicial Court of Massachusetts.

IRS CIRCULAR 230 DISCLOSURE:
To ensure compliance with requirements imposed by the IRS, we inform you that any U.S. tax advice contained in this communication (including any attachments) is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding penalties under the Internal Revenue Code or (ii) promoting, marketing or recommending to another party any transaction or matter addressed herein.

View previous month...

Director of SEC's Division of Investment Management speaks regarding exchange traded funds (ETFs) and other issues

June 24, 2002 2:33 PM

As requested by SEC Chairman Harvey Pitt, the staff of the Division of Investment Management is considering whether exemptions for exchange traded funds under the 1940 Act should be codified, division director Paul Roye said June 24, 2002. In remarks to reporters at a conference of the National Association of Variable Annuities ("NAVA"), Mr. Roye suggested that if a rule proposal is crafted, at this point it would probably deal only with stock index ETFs, which have existed for nearly a decade.

"What we're looking at is a possible ETF rulemaking. Some of it has become fairly standard," Mr. Roye said. He noted that relief granted for stock index ETF products is "fairly standard." There are now applications for ETFs that match the returns of various fixed income indexes, he noted. In addition, Mr. Roye indicated that staff in the division are giving comments on at least one application for actively managed ETFs, and continue to have a dialogue with others who are interested in sponsoring actively managed ETFs. Applications for SEC exemptive orders are pending for applicants seeking to introduce ETFs based on fixed income securities and seeking to sell ETF shares into the secondary market without prospectus delivery in certain circumstances.

In other remarks at the NAVA conference, Mr. Roye stressed that his division is reviewing its rules and interpretations, focusing on Chairman Pitt's urging to make them more efficient and effective. According to Mr. Roye, relief in the area of exemptive applications for "substitutions" is "ripe for rulemaking consideration." In January of this year, Mr. Roye stated that the staff of the Division of Investment Management was seeking to develop a consistent approach to its handling of requests by insurance companies to substitute underlying funds supporting variable products. Traditionally, applications for substitutions were filed chiefly by insurance companies that were facing unforeseen circumstances caused by changes in the underlying fund. Now, however, the staff receives numerous applications reflecting changes in insurance companies' strategic business plans.

Mr. Roye indicated that another possibility is a proposal for an exemptive rule to permit mixed and shared funding – such as when an underlying fund sells its shares to variable life insurance separate accounts in addition to variable annuity separate accounts or sells its shares to accounts of multiple insurance companies.

Mr. Roye also addressed the subject of funds that attempt to discourage market timers from using their funds as short-term trading vehicles, setting forth two approaches to the issue:

- Funds that sell to multiple insurers can establish a redemption fee class of shares to be sold to certain separate accounts, while a different class that does not impose the fee is sold to others.
- An insurance company can impose slower exchange methods – "like the U.S. mail" – on certain contract holders without imposing the same requirements on all customers.

Industry proposals to delay requested exchange transactions between funds for some period of time, or to delay the purchase portion of the exchange for some period of time after the redemption portion has been completed, are also being considered, according to Mr. Roye. (BNA Securities Law Reporter, Vol. 34 No. 26, July 1, 2002)

Massachusetts.

IRS CIRCULAR 230 DISCLOSURE:

To ensure compliance with requirements imposed by the IRS, we inform you that any U.S. tax advice contained in this communication (including any attachments) is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding penalties under the Internal Revenue Code or (ii) promoting, marketing or recommending to another party any transaction or matter addressed herein.

U.S. Supreme Court allows replacement of fund’s investment adviser to stand

June 24, 2002 2:27 PM

On June 24, 2002, the U.S. Supreme Court refused to review a federal appeals court’s conclusion that a mutual fund’s independent trustees were within their discretion under the business-judgment rule when they replaced the fund’s investment adviser. The U.S. Court of Appeals for the Ninth Circuit in August 2001 rejected the plaintiff-shareholders’ claims, affirming that the lower court properly dismissed these claims. Shareholders asserted violations of the Investment Company Act of 1940 (the “1940 Act”) and other Delaware state law violations based on the decision of the fund’s independent trustees not to renew the fund’s investment advisory contract. Among other rulings, the district court dismissed the 1940 Act and Delaware common law claims for breach of fiduciary duty, as well as state law claims for waste and interference with prospective economic advantage, against the successor adviser. Except for a ruling on sanctions, the appeals court affirmed.

In their April 30, 2002 certiorari petition, the shareholders called on the court to reverse the Ninth Circuit’s decision upholding the validity of Rule 15a-4 under the 1940 Act (i.e., that, under certain circumstances, trustees may replace the fund’s investment adviser without prior shareholder approval). Shareholders had argued on appeal that the rule “conflicts directly with §15(a) of the [1940 Act] which requires that no one can act as a mutual fund’s investment advisor without prior shareholder approval,”. (McLachlan v. Simon, U.S., No. 01-1615, 6/24/02; BNA Securities Law Reporter, Vol. 34 No. 26, July 1, 2002) in this Summary without professional legal counsel. This Summary may be considered advertising under the rules of the Supreme Judicial Court of Massachusetts.

SEC sanctions registered investment adviser and president for charging $1.7 million in excessive commissions and failing to seek best execution

June 20, 2002 2:38 PM

On June 20, 2002, the SEC imposed sanctions and a cease-and-desist order against an investment adviser and its president for overcharging $1.7 million in commissions from 1993 to 2000 and misrepresenting to the SEC and clients that it would seek best execution of client trades. Best execution generally refers to an investment adviser's obligation to seek to execute securities transactions for clients on terms that are the most favorable to the client under the circumstances. The SEC noted in its order that to fulfill this duty, investment advisers should "periodically and systematically" evaluate the execution they are receiving for clients.

In May 2000, the SEC's Office of Regulation discovered the investment adviser's practice of overcharging commissions by needlessly interpositioning a broker-dealer between clients and a market maker for over-the-counter trades. The adviser used the $1.7 million in excess commissions to compensate five registered representatives of this broker-dealer for client referrals.

In addition, although the adviser generally disclosed to clients that it could direct commissions to referring brokers, the adviser failed to disclose that:

- the $1.7 million in commissions were paid after trades were already completed on a principal basis;
- the referring broker-dealer provided no execution services; and
- the commissions paid to the referring broker-dealer exceeded the markups or markdowns already charged by the market maker

The adviser's Form ADV, which was signed by the president, also falsely stated that the adviser would seek best execution of client trades.

After the adviser learned of the investigation by the SEC's Division of Enforcement, the adviser reimbursed clients in January 2001 the $1.7 million in excessive commissions. The adviser and the president agreed to settle the charges, without admitting or denying the SEC's findings, pursuant to a public administrative and cease- and-desist proceeding. As part of the settlement, the adviser and the president agreed to pay, jointly and severally, a $50,000 civil penalty. (SEC Rel. IA-2038; File No. 3-10807; BNA Securities Law Reporter, Vol. 34 No. 26, July 1, 2002)

Investment Counsel Association of America ("ICAA") issues recommendations to SEC on regulatory effectiveness

June 18, 2002 2:41 PM

In response to the SEC's ongoing special study to examine the agency's efficiency, the ICAA issued a letter to the SEC Chairman Harvey Pitt making several recommendations for enhancing the SEC's regulatory effectiveness. The letter emphasized the need for rule making, as opposed to establishing new SEC policy informally. Specifically, the letter suggests that the SEC:

- Consolidate and make more readily available SEC staff no-action letters and other informal guidance in certain regulated areas;

- Review and revise its process of rule making with a view toward discontinuing the practice of setting new policy in SEC staff speeches and deficiency letters or by default; and
- Foster more open and regular communications among its divisions.

In addition, the ICAA requested that the SEC not institute a compliance certification system that was informally suggested by its staff in recent speeches. (Letter re. Special Study to Examine Commission Deficiency dated June 18, 2002 from David Tittsworth, Executive Director of the ICAA)

SEC staff authorizes independent directors' education as a fund expense

June 17, 2002 2:18 PM

In a recent no-action position, the staff of the SEC's Division of Investment Management agreed that the payment by mutual funds, as authorized by the boards of such funds, of the dues of their independent directors for membership in a non-profit educational organization (the "Organization") for the enhancement of mutual fund governance and related expenses would not constitute a "joint arrangement" for purposes of Section 17(d) of the 1940 Act and Rule 17(d)(1) thereunder.

Proposed activities of the Organization include:

- Providing a newsletter and email communications to members;

- Conducting annual policy conferences to discuss major policy issues of importance to fund directors;
- Offering education courses to directors;
- Gathering and distributing information to independent directors; and
- Sponsoring research regarding subjects of interest to independent directors.
- In connection with above activities, the funds would pay if reasonable, the following expenses:
- individual membership dues and attendance (for those directors electing to join);
- travel and related expenses incurred by independent directors in participating in the educational programs offered by the Organization; and
- purchasing educational information from the Organization in both hard copy and electronic formats.

Rule 17d-1 under the 1940 Act prohibits any affiliated person of a mutual fund, including any affiliated person of an affiliated person, from participating in any joint enterprise, joint arrangement or profit sharing plan in which a fund is a participant, without first obtaining SEC approval. Accordingly, it is possible that, without the relief granted, the payment of dues and other expenses in connection with participation in the activities of the Organization could be deemed to constitute a joint arrangement between a fund and an affiliated person of the fund because the independent director could in some way benefit from these payments. In arguing in favor of the relief, the Organization noted that:

- the SEC staff has stated generally that the actions of fund directors taken in their capacity as fund directors would not constitute joint arrangements for purposes of Rule 17d-1 because the necessary element of “combination” is not present
- a board’s authorization of the use of fund assets, resulting in the fund’s payment of membership dues and related expenses for the independent directors, would be within the scope and furtherance of the independent directors’ duties to the fund; and
- therefore, the authorization and resulting payment would not constitute a joint arrangement for purposes of Section 17(d) under the 1940 Act or Rule 17d-1 thereunder.

IRS CIRCULAR 230 DISCLOSURE:

To ensure compliance with requirements imposed by the IRS, we inform you that any U.S. tax advice contained in this communication (including any attachments) is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding penalties under the Internal Revenue Code or (ii) promoting, marketing or recommending to another party any transaction or matter addressed herein.

SEC Chairman Pitt addresses regulation of hedge funds and other issues

June 3, 2002 2:21 PM

At the General Membership Meeting of the Investment Company Institute on May 24, 2002, SEC Chairman Harvey Pitt addressed several current regulatory issues relating to the investment management industry.

Regulation of private funds. Chairman Pitt announced the beginning of "a formal fact-finding investigation" into hedge funds and other unregistered investment funds. According to Pitt, the investigation is intended to determine whether the unregistered status of hedge funds and other private funds creates a "regulatory arbitrage or disparity." Chairman Pitt further stated that the sole criteria the SEC will use in deciding whether hedge funds should be further regulated is "whether investors are being injured."

Rule 12b-1. Chairman Pitt stated that the SEC is examining current mutual fund distribution practices to determine whether Rule 12b-1 under the 1940 Act should be modified. Rule 12b-1 allows funds, under certain conditions, to use fund assets to pay for marketing and distribution costs. However, according to Pitt, "[p]ractices that some mutual funds and their investment advisers have implemented to pay for the marketing and distribution of fund shares have changed since Rule 12b-1 was adopted in 1980." Rule 12b-1 requires fund directors to view a fund's Rule 12b-1 plan as a temporary measure, but many funds' distribution arrangements are fully dependent on their 12b-1 plan, Pitt noted. In essence, the plan acts as a substitute for or supplement to the sales charge or as an ongoing method of paying for marketing and distribution arrangements. Pitt stated that in its inquiry the SEC will look at "the whole question of distribution, the set-up of 12b-1 plans, the notion that they're temporary, the question of what compensation is going for, what people are compensated for, and benefits to shareholders." In addition, as part of the Rule 12b-1 inquiry, the SEC will examine emerging indirect methods of financing distribution to ensure that fund directors appropriately consider these arrangements.

Proxy-Voting Policies. Chairman Pitt noted that the SEC is considering rulemaking petitions from the AFL-CIO and others requesting that mutual funds disclose proxy-voting policies and the way votes are cast. In addition, the SEC is considering whether investment advisers must disclose proxy-voting policies and their votes, particularly on contested matters.

Other matters: According to Chairman Pitt, the following other matters are also being considered by the SEC:

- improvement of shareholder reports;
- increasing the utility of fund profile documents;
- considering final adoption of amendments to fund advertising rules;
- considering final adoption of rules that would loosen restrictions governing affiliated fund mergers that prohibit certain affiliated transactions involving fund sub-advisors and portfolio affiliates;
- taking a “fresh look at [the SEC’s] prior guidance concerning electronic delivery of information under the federal securities laws”--an exercise that would extend beyond mutual funds;
- evaluating the concept of actively managed exchange traded funds (ETFs), which was explored in a concept release in November, 2001; and
- considering authorizing ETFs that match the returns of various fixed income indexes.