

# IM EXEMPTIVE APPLICATION PROCESSING

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## EXECUTIVE SUMMARY

*We reviewed the exemptive application process in the Division of Investment Management's (IM) Office of Investment Company Regulation (OICR). Our objectives were to determine whether the process was timely and to recommend improvements.*

*The timeliness of the process can be improved. Of 83 non-draft exemptive applications received in FY 2005, only 13 received initial comments within IM's guidelines of 45 days. However, OICR generally issued initial comments on deregistrations timely. Of 158 deregistrations received and for which comments were issued in FY 2005, 143 (approximately 90%) received initial comments within 45 days.*

*We are recommending several steps to enhance timeliness. These include issuing exemptive rules, filing applications electronically, and restricting or eliminating the review of draft exemptive applications.*

*Other recommendations include: returning poorly prepared applications; developing standard follow-up procedures; improving performance measures; and revising the database for exemptive applications.*

## OBJECTIVES, SCOPE AND METHODOLOGY

Our objectives were to determine whether the exemptive application process in the Division of Investment Management's Office of Investment Company Regulation (OICR) was timely and to recommend improvements. We focused on OICR because it processed approximately 94% (383 of 409) of the exemptive applications and deregistrations under the Investment Company Act of 1940 (15 U.S.C. 80a-1 et seq.) (I/C Act or the Act) received by the Commission in fiscal year 2005.

We included in our review applications for deregistrations of investment companies filed on Form N-8F because of their high volume (OICR received 287 in FY 2005). Deregistrations did not require the extent of review provided exemptive applications and were generally not reviewed by OICR staff attorneys.

We did not review the exemptive application processes in IM's Office of Insurance Products (OIP) and Office of Investment Adviser Regulation (OIA). These offices process a smaller number of exemptive applications than OICR, regarding insurance products and investment advisers.

During the audit, we interviewed OICR and other IM staff, and reviewed Commission rules, policies and procedures for exemptive application processing. Also, we analyzed FY 2005 exemptive application documentation and data generated by OICR's Applications database and the Commission's EDGAR (Electronic Data Gathering, Analysis and Retrieval) system.

We generally selected our data samples on a judgment basis. Therefore, we cannot statistically project our results to the universe of items from which we selected our samples. However, we believe that the sampled items provided reasonable support for our findings.

We conducted this performance audit between July 2005 and August 2006, in accordance with generally accepted government auditing standards (GAGAS). Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence that provides a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

## Background

The I/C Act gives the Commission the authority to issue orders granting exemptions from the I/C Act's provisions. In particular, Section 6c of the I/C Act gives the Commission the power to provide exemptions from any provision of the I/C Act or any rule under the I/C Act, provided the exemption is in the public interest, consistent with the protection of investors and consistent with the intended purposes of the I/C Act (15 U.S.C. 80a-6(c)). This authority provides flexibility in administering the I/C Act and helps the Commission achieve its strategic goal to provide a flexible regulatory environment supportive of industry innovation and competition.

Investment companies (applicants) must apply to the Commission to obtain exemptive orders. Applicants must follow the requirements in Rule 0-2 (17 C.F.R. 270.0-2) under the I/C Act and the guidance in Investment Company Release No. 14492, issued in 1985 (Release No. 14492). Release No. 14492 also includes IM's policies for processing exemptive applications.

OICR is responsible for processing investment company exemptive applications. OICR's staff includes an assistant director and four branch chiefs. Each branch consists of from three to five staff attorneys.

OICR classifies applications as either routine or novel. Routine applications request exemptive relief that OICR granted in previous applications on the same terms and conditions. OICR has already addressed the I/C Act issues related to routine applications, and expects to take less time to process routine applications than to process novel applications. Novel applications contain new I/C Act, policy or factual issues on which the IM Director or the Commission may need to decide. Consequently, OICR expects to take more time to process them.

OICR also processes applications for investment company deregistrations, which are filed electronically on Form N-8F. OICR considers these applications routine, and expects to process them relatively quickly. After OICR issues the deregistration order, the company is no longer a registered investment company.

OICR's management holds weekly meetings to discuss and assign exemptive applications to a branch chief and staff attorney. Staff attorneys may work with more than one branch chief, depending on the exemptive applications they are assigned.

The staff attorneys analyze the I/C Act issues presented in applications and prepare comments to request corrections or additional information from applicants. The staff attorneys then forward their comments on the applications to their branch chiefs, who review the applications and comments and forward their input in turn to the Assistant Director. After incorporating management's input, the staff attorney issues a comment letter to the applicant.

Release No. 14492 requires OICR to provide initial comments to applicants within 45 days. Generally, the applicant will amend the application or otherwise address the comments. The applicant then has 60 days to respond to OICR's comments, after which OICR will suspend processing of the application (inactive status) until the applicant responds.

Upon completing the review, OICR sends a summary notice of the application to the Office of the Secretary for publication in the Federal Register. After the end of the notice period (OICR generally provides 25 days), if the public did not ask for a hearing (generally the case), and the Commission does not order a hearing, OICR issues an exemptive order granting the application under delegated authority from the Commission.

The number of pending exemptive applications, including deregistrations, declined approximately 4% between the end of 2004 and the end of 2005, from 211 to 203. The number of pending applications, excluding de-registrations, declined by approximately 10%, from 177 in FY 2004 to 160 in FY 2005.

## Audit Results

We found that OICR's exemptive application process was not always timely. Of 83 non-draft exemptive applications received in FY 2005, only 13 (approximately 16%) received initial comments within the 45 day timeliness goal under the Commission guidelines in Release No. 14492.

However, OICR generally issued initial comments on deregistrations timely. Of 158 deregistrations received and for which comments were issued in FY 2005, 143 (approximately 90%) received initial comments within 45 days.

We have a number of recommendations to improve timeliness. These include issuing exemptive rules, filing applications electronically, and restricting or eliminating the review of draft exemptive applications. We discuss these and other recommendations below.

## **Exemptive Rules**

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The Commission's FY 2004-2009 strategic plan (page 39) included an initiative to adopt exemptive rules in order to reduce the number of exemptive requests from investment companies. Exemptive rules often codify the terms and conditions of prior exemptions granted on a recurring basis by the Commission. Investment companies may rely on exemptive rules instead of submitting exemptive applications.

The Commission proposed two new exemptive rules in October 2003. One rule regarded mutual fund investments in other mutual funds (fund of funds), and investments of excess cash in money market funds (cash sweeps). The other rule regarded entering or modifying advisory contracts with sub advisers without shareholder approval (multimanager). The Commission adopted the final exemptive rule regarding fund of funds and cash sweeps in June 2006 (Release Number IC-27399). The multimanager rule is still pending.

Routine applications covered by the pending exemptive rules represented unnecessary processing for OICR. At the end of FY 2005, approximately 24 fund of funds, cash sweep and multimanager applications were pending (15% of the total exemptive applications pending) that likely would have been unnecessary if the proposed rules had been adopted sooner. Also, routine applications take resources from novel applications that could promote regulatory flexibility and industry innovation.

IM's Office of Regulatory Policy (ORP) drafts I/C Act exemptive rules. ORP indicated that it had limited resources for rulemaking (five staff attorneys, a branch chief and an assistant director). Also, ORP had other rulemaking responsibilities.

### **Recommendation A**

IM should set and monitor a deadline for submitting the multimanager exemptive rule to the Commission for consideration.

## **Electronic Filing**

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The Government Paperwork Elimination Act, or GPEA (P.L. 105-277, Title XVII, October 21, 1998), requires Federal agencies to allow individuals and entities the option to submit information to Federal agencies in electronic form to the extent practicable. However, Rule 0-2 and the EDGAR rules still require that applicants submit exemptive applications in paper.

Electronic filing of exemptive applications could improve timeliness of processing by reducing the amount of manual processing. The Commission's mailroom would not have to manually stamp these applications and deliver them to the Office of Filings and Information Services (OFIS). OFIS would not have to manually input data from exemptive applications into EDGAR and deliver the applications to OICR. Also, electronic filing would minimize physical handling of applications and reduce the risk of delayed receipt and loss of applications.

In FY 2002, IM requested funding for an EDGAR requirements analysis for electronic filing of exemptive applications. IM indicated that funding was not provided because of other priorities.

## Recommendation B

IM should continue to seek electronic filing for exemptive applications and propose amendments to the applicable Commission rules to allow electronic filing of exemptive applications.

### Draft Applications

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Applicants may send draft exemptive applications to OICR to obtain preliminary views on novel applications (*e.g.*, related to exchange-traded funds). OICR received 13 draft exemptive applications in FY 2005.

Draft applications allowed applicants' proposals to remain confidential during OICR's initial review. To further ensure confidentiality, applicants requested confidential treatment for their draft applications.

IM's policy in Release 14492 provides that IM will not review draft applications, except in the "most extraordinary circumstances." Also, reviewing draft applications takes resources away from reviewing formally submitted applications.

IM is in the process of updating its policies and guidelines for the review of exemptive applications. These guidelines should clarify IM's requirement that applicants justify their "extraordinary circumstances" when submitting draft applications.

## Recommendation C

IM should require applicants to justify their "extraordinary circumstances" for submitting draft applications.

### Deficient Applications

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According to Release No. 14492, exemptive applications should be adequately detailed and justified. OICR implements this requirement by commenting on applications and requesting amendments addressing relevant issues.

However, OICR did not have policies and procedures that prevented it from spending unnecessary time reviewing "clearly deficient" applications. Release No. 14492 describes "clearly deficient" applications as those that did not comply with the Commission's procedural rules or that misstated or lacked adequate facts and analysis. OICR issued extensive comments on these applications or requested that applicants withdraw them.

We reviewed a judgment sample of 15 comment letters relating to 15 of 154 exemptive applications (excluding deregistrations) filed in FYs 2004 and 2005. Five comment letters requested substantial rewording of the investor protection conditions in the applications. Another comment letter requested substantial rewording of almost the entire application. These types of applications, while not the majority, occupy OICR resources that could have been applied to better prepared applications.

OICR properly assisted many applicants in refining their requests for exemptive relief. However, OICR should have the option to return "clearly deficient" applications rather than investing its limited resources in processing them.

OICR is in the process of updating its policies and guidelines for the review of exemptive applications. These guidelines should include policies and procedures for returning “clearly deficient” applications to the applicant.

### **Recommendation D**

IM should develop policies and procedures to identify “clearly deficient” applications and to return them to the applicant without a detailed review.

### **Follow-Up**

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Some OICR attorneys, on a case-by-case basis, will contact applicants for updates during processing of an application or after the 60 day deadline for responding to comment letters has passed without a response. However, OICR does not have a standard procedure for contacting all applicants.

Follow-up procedures would help OICR consistently and timely identify issues during its review (e.g., abandoned applications, changes in contact persons, arrangements for extensions of time for responses to comments).

OICR is in the process of updating its policies and guidelines for the review of exemptive applications. These guidelines should include policies and procedures for timely follow-up.

### **Recommendation E**

OICR should develop and implement standard policies and procedures for contacting the applicant during its review of exemptive applications.

### **Performance Measures**

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#### **Goals**

The Office of Management and Budget (OMB) requires agencies to develop performance measures that provide information on progress toward its goals. The Commission’s FY 2004-2009 strategic plan includes goals to provide regulatory flexibility and support industry innovation. OICR’s exemptive application process supports these Commission goals, but OICR had not yet developed outcome goals for the process. Outcome goals would help OICR describe how its activities and achievements supported the Commission’s goals.

OICR also needs to develop timeliness goals for its novel exemptive applications. Release No. 14492 included a timeliness goal of 45 days to initial comments for exemptive applications, but did not distinguish between routine and novel applications. Release No. 14492 recognized that novel applications would take longer to process. Separate timeliness goals for novel applications would enhance performance measurement and reporting.

We recognize that OICR might not always meet its timeliness goals, particularly for routine applications that were poorly prepared or novel applications with complex I/C Act issues. However, the information provided by tracking these goals would help OICR to identify and analyze trends and the causes of delays.

OICR also has not developed goals for the interim stages of exemptive application processing (*e.g.*, the number of days for staff and management review). Such measures would be useful to OICR.

### **Recommendation F**

OICR should develop, track, and report outcome goals for its exemptive application process and timeliness goals for its novel exemptive applications. If needed, OICR should obtain appropriate guidance or training in developing performance measures.

### **Closed Applications**

For reporting purposes, OICR counted as closed those exemptive applications in inactive status or those for which it had published Federal Register notices. However, inactive applications may be reactivated for further processing if the applicant submits an amended application in response to OICR's comments. A Federal Register notice is published before an exemptive order is issued, and the notice could result in a Commission hearing (although these hearings are rare). Consequently, exemptive applications should only be considered closed when OICR issues an exemptive order or the applicant formally withdraws its exemptive application.

### **Recommendation G**

OICR should only count exemptive applications as closed for reporting purposes when it issues an exemptive order or the applicant formally withdraws its application.

### **Application Information on Website**

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The Commission's website includes links to I/C Act laws and rules, staff guidance and studies, investor information and no-action letters. However, the site does not provide information related to exemptive applications such as Release No. 14492 or Federal Register notices of applications and exemptive orders.

This information is available from a number of other sources (*e.g.*, the "SEC Docket" or the Federal Register). However, posting the information on the website would enhance public access.

### **Recommendation H**

IM should post Federal Register notices, exemptive orders, and related policies and procedures on the Commission's public website.

### **Employee Securities Companies**

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Employee Securities Companies (ESCs) are pools of funds contributed by a company's employees that the company then invests in securities. A Commission rule provides ESCs with an automatic exemption that allows them to operate while their applications are pending final determination by the Commission.

The ESC rule was adopted in 1941, and may need updating. Options include issuing a new or modified rule, or eliminating the ESC automatic exemption rule.

ESC applications are generally not reviewed timely. OICR had a backlog of about 35 ESC applications as of the end of 2005, which had been pending an average of approximately 4 years. IM's policy generally requires OICR to review exemptive applications in the order received. However, OICR places a low priority on ESC applications because they operated under automatic exemptions and are not considered high-risk.

Nevertheless, the ESC backlog is significant because these applications have not received the benefit of OICR's review. Since the automatic exemption contemplates subsequent review and action on an ESC application, OICR is considering, among other things, assembling a task force to process the backlog of ESCs.

### **Recommendation I**

IM should determine whether and how the ESC rule should be updated, and submit the appropriate recommendations to the Commission.

### **Recommendation J**

IM should address the backlog of ESCs (*e.g.*, by forming a task force).

## **Deregistration Applications**

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We reviewed data on a random sample of 50 out of 279 investment company deregistration applications on Form N-8F for which orders were issued in FY 2005. Twenty-seven of these companies did not appear to have submitted their semi-annual reports on form N-SAR as required by Commission rules.

Investment companies must file form N-SAR to provide oversight information to IM on investment companies' investment advisers, investment portfolios, and financial condition. The deregistration form includes a reminder to timely file a final form N-SAR with the Commission.

OICR does not monitor whether applicants for deregistration continue to file N-SARs, and the filing of these reports is not a condition for approval of their deregistration. OICR feels that it is not cost effective to raise this issue with these funds because the funds often lack resources to file the reports.

### **Recommendation K**

IM should determine whether the requirement for semi-annual reports from funds applying for deregistration should be revised or eliminated. If so, IM should submit the appropriate recommendation to the Commission. If not, OICR should enforce the requirement.

## **Database**

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OICR maintains a database on exemptive applications and deregistrations. It has updated the database over the last few years, but OICR is still not satisfied with it. For example, the system does not provide workload numbers for the Chairman's Dashboard reports.

The Office of Information Technology (OIT) provides a Walk-In Development Center (WIDC) to help Commission Offices and Divisions with their IT systems, including

databases. It helped OICR to develop queries for its database, and might be able to help OICR complete the update.

### **Recommendation L**

OICR should complete the update of the Applications database, consulting with OIT and the WIDC if necessary.

### **Proposed Federal Register Notices**

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Applicants are required by Rule 0-2 to submit proposed Federal Register notices, summarizing their request for relief, with their exemptive applications. However, OICR staff do not generally use these proposed notices because of the amount of revision required. Instead, OICR drafts its own Federal Register notices after applicants revise their applications in response to comments.

Consequently, applicants spend their time and resources preparing and submitting proposed Federal Register notices that OICR rarely uses. Also, the draft notices increase paperwork for OICR and the Commission's Office of Filings and Information Services.

### **Recommendation M**

IM should submit a recommendation to the Commission to eliminate the requirement that applicants submit proposed Federal Register notices with their exemptive applications.