

ACT ICA

SECTION 12(d)(3)

RULE 12d3-1

PUBLIC

7/6/00

July 6, 2000

Our Ref. No. 98-733-CC

Select Sector SPDR Fund

and Diamonds Trust

File Nos. 811-8837; 811-9170

RESPONSE OF THE OFFICE OF CHIEF COUNSEL  
DIVISION OF INVESTMENT MANAGEMENT

Your letter of June 23, 2000 requests our assurance that we would not recommend enforcement action to the Securities and Exchange Commission under Section 12(d)(3) of the Investment Company Act of 1940 (the "1940 Act") against The Financial Select Sector SPDR Fund or the Diamonds Trust if any of them invests more than 5% of its total assets in the securities of a securities-related issuer, as defined below.

FACTS

The Financial Select Sector SPDR Fund

The Financial Select Sector SPDR Fund (the "Financial Sector Fund") is a series of The Select Sector SPDR Trust, a registered open-end management investment company.<sup>1</sup> State Street Bank and Trust Company ("State Street") is the investment adviser to the Financial Sector Fund. You state that the investment objective of each series of The Select Sector SPDR Trust (each, a "Fund"), including the Financial Sector Fund, is to provide investment results that correspond generally to the price and yield performance of publicly traded equity securities of companies in a particular industry group as represented by a specific market sector (each, a "sector index")<sup>2</sup> of the Standard & Poor's Composite Stock Index (the "S&P 500").<sup>3</sup>

<sup>1</sup> You state that each series of The Select Sector SPDR Trust issues and redeems its shares, which are called "Creation Units," in exchange for the securities that comprise the series' sector index. A Creation Unit is comprised of individually non-redeemable, exchange-traded shares called SPDRs. The Select Sector SPDR Trust operates in this manner pursuant to a Commission exemptive order. See The Select Sector SPDR Trust, et al., Investment Company Act Release Nos. 23492 (Oct. 20, 1998) (notice) and 23534 (Nov. 13, 1998) (order).

<sup>2</sup> You state that each Fund currently invests in the securities of issuers in one of nine separate sectors: basic industries, consumer services, consumer staples, cyclical/transportation, energy, financial, industrial, technology, and utilities. You state that the issuers of the securities in those nine sectors together comprise all of the companies in the S&P 500.

<sup>3</sup> You state that Standard & Poor's is not affiliated with The Select Sector SPDR Trust, or State Street, and has not participated, and will not participate, in the creation of the Funds or the selection of the stocks purchased by the Funds.

You state that each sector index was established in the following manner: Merrill Lynch, Pierce, Fenner & Smith Incorporated ("Merrill Lynch")<sup>4</sup> assigned each component security of the S&P 500 to one sector index, based on the general industry classification of the companies included in the S&P 500. Each sector index is calculated by using a "market capitalization" methodology, in which each component stock within a sector index is represented in the sector index in proportion to the component stock's percentage of the total market capitalization of the sector index. You also state that the American Stock Exchange LLC ("AMEX") publishes the sector indexes.

You state that some of the issuers in the S&P 500 derive a substantial portion of their revenues from securities-related activities. You represent that the investment objective of the Financial Sector Fund is to provide investment results that correspond generally to the price and yield performance of the companies in the financial sector index, which consists of financial service firms whose businesses range from investment management to commercial and investment banking.<sup>5</sup> You state that State Street manages the Financial Sector Fund by attempting to approximate the investment performance of the financial sector index through investments in a portfolio of stocks that replicate the financial sector index, or through the use of quantitative analytical procedures to approximate the financial sector index's performance. You state that State Street may exercise discretion over what particular stocks the Financial Sector Fund may hold.<sup>6</sup> You state, however, that the Financial Sector Fund generally will hold all of the securities that comprise the financial sector index. You further represent that the Financial Sector Fund will purchase and maintain its position in the stock of any securities-related issuer, as defined below, only in the approximate proportion that the stock is represented in the financial sector index.

#### Diamonds Trust

The Diamonds Trust is a registered unit investment trust sponsored by the PDR Services Corporation, a wholly owned subsidiary of AMEX.<sup>7</sup> State Street is the trustee of the Diamonds

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<sup>4</sup> You state that Merrill Lynch is not affiliated with State Street or The Select Sector SPDR Trust.

<sup>5</sup> You state that the S&P 500 and the financial sector index include, among others, the following financial services firms: American Express Co.; Charles Schwab Corp.; Lehman Bros. Holdings Inc.; Merrill Lynch and Co., Inc.; Morgan Stanley Dean Witter & Co.; and Citigroup, Inc.

<sup>6</sup> You state that there may be instances in which the Financial Sector Fund does not hold a stock that is included in the financial sector index or does not hold the stock in the same weighting that the stock has in the sector index.

<sup>7</sup> You state that the Diamonds Trust also issues and redeems its shares, which are called "Creation Units," in exchange for the securities that comprise the Dow Jones Industrial Average

Trust. You state that the investment objective of the Diamonds Trust is to provide investment results that correspond generally to the price and yield performance of publicly traded equity securities as represented by the DJIA,<sup>8</sup> which consists of thirty stocks that are represented in equal share amounts.

You state that the Diamonds Trust utilizes an indexing approach in attempting to approximate the DJIA's investment performance. The Diamonds Trust holds a portfolio of securities consisting of all of the component common stocks of the DJIA in equal share amounts. You state that State Street will not substitute stocks that are not components of the DJIA for those that are, nor will it adjust the weighting of the DJIA stocks to deviate from the DJIA weighting.

You state that the Diamonds Trust holds a portfolio of securities consisting of representative amounts of all of the component common stocks of the DJIA, which includes issuers that derive a substantial portion of their revenue from securities-related activities. You state that many of these companies are financial service firms whose businesses range from investment management to commercial and investment banking.<sup>9</sup>

#### ANALYSIS

Section 12(d)(3) of the 1940 Act generally prohibits a registered investment company from purchasing securities issued by a broker, dealer, registered investment adviser, or underwriter. Rule 12d3-1 under the 1940 Act, however, exempts purchases of these securities from the prohibitions of Section 12(d)(3) under certain circumstances. Paragraph (a) of Rule 12d3-1 permits an investment company to acquire any security issued by any person that, in its most recent fiscal year, derived 15% or less of its gross revenues from securities-related

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(the "DJIA"). A Creation Unit is comprised of individually non-redeemable, exchange-traded units called Diamonds. The Diamonds Trust operates in this manner pursuant to a Commission exemptive order. See Diamonds Trust, et al., Investment Company Act Release Nos. 22927 (Dec. 5, 1997) (notice) and 22979 (Dec. 30, 1997) (order).

<sup>8</sup> You state that the Dow Jones & Company, Inc. is not affiliated with the Diamonds Trust, State Street, or PDR Services Corporation, and has not participated, and will not participate, in the creation of the Diamonds Trust or the selection of stocks purchased by the Diamonds Trust. Telephone conversation between Kathleen Knisely of the staff and Robert Robertson of Mayer, Brown & Platt on July 6, 2000.

<sup>9</sup> You state that the DJIA includes, among others, the following financial services firms: American Express Co.; J.P. Morgan & Company Inc.; and Citigroup, Inc.

activities<sup>10</sup> unless the investment company would control such person after the acquisition. Paragraph (b)(3) of Rule 12d3-1 permits an investment company to invest up to 5% of the value of its total assets in the securities of an issuer that derives more than 15% of its gross revenues from securities-related activities (a "securities-related issuer"). You state that the Financial Sector Fund and the Diamonds Trust (collectively, the "Index Funds") may not invest in securities-related issuers to the extent that is necessary for them to track their respective indexes consistent with the limitations contained in Section 12(d)(3) of the 1940 Act and Rule 12d3-1 thereunder because certain securities-related issuers comprise more than 5% of the financial sector index and the DJIA.

Congress adopted Section 12(d)(3) for two purposes: (i) to limit the exposure of registered investment companies to the entrepreneurial risks peculiar to investing in securities-related businesses; and (ii) to prevent potential conflicts of interest and certain reciprocal practices.<sup>11</sup> With respect to Congress's concerns about entrepreneurial risks, you state that in 1940 most securities-related businesses were organized as privately held general partnerships. If a securities-related business failed, the investment company as a general partner could have been held accountable for the partnership's liabilities. You note that today virtually all securities firms are organized as corporations and not as general partnerships. In addition, you argue that paragraph (c) of Rule 12d3-1, which effectively precludes an investment company from acquiring general partnership interests in a broker, dealer, registered investment adviser, or underwriter, adequately addresses Congress's concern regarding an investment company's exposure to the entrepreneurial risks of investing in a securities-related business.<sup>12</sup>

With respect to Congress's concerns about potential conflicts of interest and reciprocal practices, the Commission has identified two potentially abusive reciprocal practices. First, an investment company might purchase the securities of a broker-dealer to reward the broker-dealer for selling the investment company's shares.<sup>13</sup> You argue that the investment objectives and

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<sup>10</sup> Rule 12d3-1(d)(1) defines "securities related activities" as a person's activities as a broker, a dealer, an underwriter, an investment adviser registered under the Investment Advisers Act of 1940, or an investment adviser to a registered investment company.

<sup>11</sup> See Exemption of Acquisitions of Securities Issued by Persons Engaged in Securities Related Businesses, Investment Company Act Release No. 19204 (Jan. 4, 1993) (citing) Investment Trusts and Investment Companies: Hearings on S. 3580 before a Subcomm. of the Comm. on Banking and Currency, 76th Cong., 3d Sess. 243 (1940).

<sup>12</sup> Rule 12d3-1(c) provides that the exemption from Section 12(d)(3)'s prohibition on the acquisition of securities issued by a broker, dealer, registered investment adviser, or underwriter is not available for the acquisition of a general partnership interest in these entities.

<sup>13</sup> See Acquisition by Registered Investment Companies of the Equity Securities of Foreign Securities Firms, Investment Company Act Release No. 17096 (Aug. 3, 1989).

policies of the Index Funds prevent them from purchasing securities of broker-dealers as a reward for selling the Funds' shares. You represent that State Street will not exercise any discretion with respect to an Index Fund's purchase or sale of the stock of securities-related issuers; State Street will purchase stock of the securities-related issuers in the approximate proportion to which the stock comprises the applicable index.<sup>14</sup> We agree that the Index Funds cannot purchase the securities of a broker-dealer as a reward for selling the Index Funds' shares, if they comply with their stated investment objectives and policies.<sup>15</sup>

The second potential abuse that the Commission identified was that an investment company might direct brokerage transactions to a broker-dealer in which the investment company had invested, even if the broker-dealer did not offer the best price or execution, to enhance the broker-dealer's profitability or to assist the broker-dealer during financial difficulties.<sup>16</sup> You represent that the Index Funds will not direct brokerage transactions to

<sup>14</sup> You state, however, that under certain circumstances each Index Fund may adjust the number of shares of a component stock of the applicable index that is held in its portfolio, in order for the Fund to retain its status as a "regulated investment company" as defined in Subchapter M of the Internal Revenue Code of 1986. Telephone conversation between Kathleen Knisely of the staff and Robert Robertson of Mayer, Brown & Platt on July 6, 2000.

<sup>15</sup> We note that some investment companies (each, a "fund") have received orders under Sections 6(c) and 12(d)(3) to permit each fund to invest over 5% of the fund's total assets in the stock of a securities-related issuer. Generally, these funds have investment policies that require them to invest more than 5% of their total assets in the common stock of a single issuer that is selected through objective criteria; these funds do not make discretionary investment decisions. For example, a fund may be required by its policies to purchase the 5 common stocks that have the highest dividend yield of the stocks comprising the DJIA. As in the case of an Index Fund, we believe that such investment policies prevent a fund from purchasing the securities of a securities-related issuer in order to reward a broker-dealer for selling the fund's shares. See, e.g., JNL Variable Fund LLC, Investment Company Act Release Nos. 24106 (Oct. 21, 1999) (notice) and 24136 (Nov. 16, 1999) (order); Select Ten Plus Fund, LLC, Investment Company Act Release Nos. 24003 (Sept. 9, 1999) (notice) and 24063 (Sept. 30, 1999) (order); Dow Target Variable Fund LLC, Investment Company Act Release Nos. 23938 (Aug. 10, 1999) (notice) and 23986 (Sept. 1, 1999) (order); First Defined Portfolio Fund LLC, Investment Company Act Release Nos. 23858 (June 4, 1999) (notice) and 23888 (July 1, 1999) (order); Dow Target Variable Fund LLC, Investment Company Act Release Nos. 23591 (Dec. 8, 1998) (notice) and 23628 (Dec. 30, 1998) (order); Integrity Life Insurance Company, et al., Investment Company Act Release Nos. 23424 (Sept. 2, 1998) (notice) and 23474 (Sept. 29, 1998) (order); and PFL Endeavor Target Account, et al., Investment Company Act Release Nos. 23241 (June 5, 1998) (notice) and 23298 (July 1, 1998) (order).

<sup>16</sup> See Exemption for Acquisition by Registered Investment Companies of Securities Issued by Persons Engaged Directly or Indirectly in Securities Related Businesses, Investment Company Act Release No. 13725 (Jan. 17, 1984).

enhance a broker-dealer's profitability or to assist a broker-dealer during financial difficulty.<sup>17</sup>

u represent that when selecting broker-dealers to execute the purchase and sale of portfolio securities, State Street chooses broker-dealers for the Index Funds that obtain prompt execution of orders at favorable prices.<sup>18</sup> You represent that the Diamonds Trust will not use any securities-related issuer whose securities represent more than 5% of the Diamonds Trust's total assets, or any affiliated person of such an issuer, as a broker for the purchase or sale of any security in the Diamond Trust's portfolio. In addition, you represent that the Financial Sector Fund will comply with the provisions of Section 17(e) and Rule 17e-1 under the 1940 Act when using as a broker any securities-related issuer that represents more than 5% of the Financial Sector Fund's total assets, or any affiliated person of such an issuer.<sup>19</sup> The Financial Sector Fund will comply with all of those provisions regardless of whether the securities-related issuer (or any

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<sup>17</sup> Telephone conversation between Kathleen Knisely of the staff and Robert Robertson of Mayer, Brown & Platt on July 6, 2000.

<sup>18</sup> You acknowledge State Street's obligation, under the federal securities laws, to seek to obtain best execution in purchasing or selling the Index Funds' portfolio securities. See, e.g., In the Matter of Fleet Investment Advisers Inc. (As Successor to Shawmut Investment Advisers, Inc.), Investment Advisers Act Release No. 1821 (Sept. 9, 1999); In the Matter of Synovus Securities, Inc., and Clark L. Reed, Jr., Investment Advisers Act Release No. 1423; In the Matter of Michael L. Smirlock, Investment Advisers Act Release No. 1393 (Nov. 29, 1993); In the Matter of Edgemont Asset Management Corp., and Bowling Green Securities, Inc., Investment Advisers Act Release No. 1280 (June 18, 1991); Brokerage and Research Services, Securities Exchange Act Release No. 23170 (Apr. 23, 1986) and; In the Matter of Delaware Management Company, Inc., et al., Securities Exchange Act Release No. 8128 (July 19, 1967). See also In the Matter of Kidder, Peabody & Co. Inc., Edward B. Goodnow, Investment Advisers Act Release No. 232 (Oct. 16, 1968).

<sup>19</sup> Section 17(e)(1) generally limits the amount of compensation that an investment company may pay to an affiliated person for effecting purchases and sales of securities on a securities exchange to the usual and customary broker's commission. Rule 17e-1 defines "usual and customary broker's commission" and requires that an investment company's board of directors: (i) adopt certain procedures to ensure that the commission paid by the investment company does not exceed the usual and customary broker's commission; (ii) review the continued appropriateness of such procedures annually; and (iii) review transactions quarterly to determine that they comply with these procedures. You state that the Financial Sector Fund will comply with all of the provisions of Section 17(e)(1) and Rule 17e-1 in order to ensure that the securities-related issuers whose securities the fund owns do not charge the Financial Sector Fund excessive commissions on brokerage transactions. Telephone conversation between Kathleen Knisely of the staff and Robert Robertson of Mayer, Brown & Platt on July 6, 2000. You note that as a unit investment trust, the Diamonds Trust does not have a board of directors that could review the trust's brokerage transactions in accordance with provisions of Section 17(e) of the 1940 Act and Rule 17e-1 thereunder.

affiliated person of such an issuer) is affiliated with the Financial Sector Fund. You believe that State Street's and the Diamond Trust's policies stated above, and the Financial Sector Fund's compliance with those provisions, would provide adequate safeguards against the concerns about reciprocal practices and conflicts of interest that the adoption of Section 12(d)(3) was intended to address.<sup>20</sup>

For the reasons set forth above, you believe that your proposal does not raise the concerns that underlie Section 12(d)(3). We agree. Accordingly, we would not recommend that the Commission take enforcement action under Section 12(d)(3) of the 1940 Act against an Index Fund if the Index Fund invests more than 5% of its total assets in the securities of a securities-related issuer in the manner described in your letter. This position is based on the facts and representations contained in your letter, particularly your representations that:

- (1) each Index Fund's investment objective is to match the investment performance of an unaffiliated broad-based securities market index or an index that is based on sector classifications of such an unaffiliated, broad-based securities market index;<sup>21</sup>
- (2) each Index Fund will comply with its stated investment objective and policies;
- (3) each Index Fund will purchase and maintain any position in a securities-related issuer only in the approximate proportion that the issuer's stock is represented in the relevant index, except insofar as may be necessary for the fund to retain its status as a regulated investment company as defined in Subchapter M of the Internal Revenue Code of 1986;<sup>22</sup>

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<sup>20</sup> Telephone conversation between Kathleen Knisely of the staff and Robert Robertson of Mayer, Brown & Platt on July 6, 2000. You also assert that, due to the Index Funds' investment objectives, it would be extremely unlikely that the amount of brokerage transactions that a Fund could direct to any broker-dealer that is included in the S&P 500 or the DJIA would have any significant effect on the market value or profitability of the broker-dealer. You also argue that the Index Funds' portfolio turnover is substantially less than that of investment companies that are not index funds because State Street manages the Funds' portfolios according to the indexing method described above. In addition, you assert that the amount of brokerage transactions resulting from purchase and redemption requests for Creation Units is greatly diminished because generally the Index Funds only purchase and redeem their shares in-kind. Telephone conversation between Kathleen Knisely of the staff and Robert Robertson of Mayer, Brown & Platt on July 6, 2000.

<sup>21</sup> We believe that those funds that have received orders under Sections 6(c) and 12(d)(3) may rely on this letter to purchase and maintain their positions in certain securities-related issuers. Alternatively, those funds may continue to rely on their orders. See note 14, supra.

<sup>22</sup> You represent that each Index Fund's portfolio will not be adjusted so as to reward any securities-related issuer for selling shares of the Fund. Telephone conversation between Kathleen Knisely of the staff and Robert Robertson of Mayer, Brown & Platt on July 6, 2000.

(4) each Index Fund will comply with all of the provisions of Rule 12d3-1 under the 1940 Act except paragraph (b)(3);

(5) if the Financial Sector Fund has invested more than 5% of the value of its total assets in the securities of a securities-related issuer, the Fund will comply with the provisions of Section 17(e) and Rule 17e-1 under the 1940 Act when using that issuer, or any affiliated person of that issuer, as a broker for the purchase or sale of any security in the fund's portfolio; and

(6) if the Diamonds Trust has invested more than 5% of the value of its total assets in the securities of a securities-related issuer, the Trust will not use that issuer, or any affiliated person of that issuer, as a broker for the purchase or sale of any security in the Trust's portfolio.

This response expresses the Division's position on enforcement action only and does not express any legal conclusions on the issues presented. Because this position is based on the facts and representations in your letter, you should note that any different facts or circumstances might require a different conclusion.

Kathleen L. Knisely  
Senior Counsel

A handwritten signature in black ink, appearing to read 'Kathleen L. Knisely', written in a cursive style.

# MAYER, BROWN & PLATT

1675 BROADWAY

NEW YORK, NEW YORK 10019-5820

June 23, 2000

Douglas J. Scheidt, Associate Director  
Office of Associate Director (Chief Counsel)  
Securities and Exchange Commission  
450 5th Street, N.W.  
Washington, DC 20549

Re: Index Funds and Section 12(d)(3)

Dear Mr. Scheidt:

We request assurances that the Division of Investment Management of the Securities and Exchange Commission will not recommend any enforcement action to the Commission under Section 12(d)(3) of the Investment Company Act of 1940 if our "index fund" clients invest in securities-related issuers as described in this letter. We believe the investments, if properly structured, are consistent with the provisions of Section 12(d)(3).

## **The Index Funds**

The Select Sector SPDR Trust will offer several investment portfolios — the "Select Sector SPDR Funds" — that seek to track the performance of specified market sectors represented in the Standard & Poor's 500 Composite Stock Index (the "S&P 500"). The "Diamonds Trust" seeks to track the performance of the Dow Jones Industrial Average (the "DJIA"). The Financial Select Sector SPDR Fund ("Financial Sector Fund"), a portfolio of the Select Sector SPDR Trust, and the Diamonds Trust are collectively referred to in this letter as the "Index Funds." Each Index Fund may invest more than 5% of its assets in a securities-related business if the investment is consistent with its investment objective.

### *Select Sector SPDR Funds*

The Financial Sector Fund is an investment portfolio of The Select Sector SPDR Trust, a registered open-end investment company under the Investment Company Act. State Street Bank and Trust Company ("State Street") is the investment adviser to the Financial Sector Fund.

The investment objective of each Select Sector SPDR Fund, including the Financial Sector Fund, is to provide investment results that correspond generally to the price and yield performance of publicly traded equity securities of companies in a particular industry group as represented by a specific market sector of the S&P 500. The companies in each index are selected on the basis of general industry classification from companies included in the S&P 500. The S&P 500 consists of 500 stocks and is one of the most widely used benchmarks of U.S. stock performance. Standard and Poor's is not affiliated with the Select Sector SPDR Trust or State Street, and has not participated, and will not participate in the creation of the Funds or the selection of the stocks purchased by the Funds. As of May 23, 2000, the issuers of the stocks in the index had a minimum individual market capitalization of \$360 million, with an average of

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\$23.5 billion; their minimum daily trading volume was 2 thousand, with an average of 1.4 million.

The nine sectors upon which the Select Sector SPDR Funds are based together comprise all of the companies in the S&P 500. Each Select Sector SPDR Fund currently invests in the securities of issuers in one of nine separate sectors: basic industries, consumer services, consumer staples, cyclical/transportation, energy, financial, industrial, technology, and utilities. Each of the component securities in the sector indexes will be a company represented in the S&P 500. Each stock in the S&P 500 is allocated to one and only one of the sector indexes, and each constituent stock of the S&P 500 has been assigned to a sector index by Merrill Lynch, Pierce, Fenner & Smith Incorporated (“Merrill Lynch”). Merrill Lynch is not affiliated with State Street or The Select Sector SPDR Trust. Each sector index is calculated using the “market capitalization” methodology; that is, each component stock within a sector index is represented in the sector index in proportion to the component stock’s percentage of the total market capitalization of the index. Under certain conditions, however, the number of shares of a component stock within a sector index may be adjusted in order for the Fund to retain its status as a “regulated investment company” as defined in Subchapter M of the Internal Revenue Code. The sector indexes are published by the American Stock Exchange LLC (“AMEX”).<sup>1</sup>

The Financial Sector Fund is not managed according to traditional methods of “active” investment management involving the buying and selling of securities based upon economic, financial and market analyses and investment judgment. Instead, the Financial Sector Fund utilizes an indexing investment approach, attempts to approximate the investment performance of its sector index by investing in a portfolio of stocks that replicate the relevant index or through the use of quantitative analytical procedures to approximate index performance.

State Street anticipates that, generally, the Financial Sector Fund will hold all of the securities that comprise the Fund’s sector index. State Street may exercise discretion over what particular stocks the Financial Sector Fund may hold. There may, however, be instances where a stock in the applicable sector index is not held or is not held in the same weightings as in the index. In certain instances, State Street may choose to overweight another stock in the sector index, purchase securities not included within the index which State Street believes are appropriate to substitute for the index securities or utilize various combinations of other available investment techniques in seeking to track accurately the benchmark index.

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<sup>1</sup> “Standard & Poor’s®”, “S&P®”, “S&P 500®”, “Standard & Poor’s 500®”, “500®”, “Standard & Poor’s Depository Receipts®”, “SPDR®”, “Select Sector SPDR”, “Select Sector SPDRs” and “Select Sector Standard & Poor’s Depository Receipts” are trademarks of The McGraw-Hill Companies, Inc. and have been licensed for use in connection with the listing and trading of shares of the Select Sector SPDR Funds on the AMEX. Shares of the Select Sector SPDR Funds, however, are not sponsored, endorsed, sold or promoted by Standard & Poor’s. Nor are the shares of Select Sector SPDR Funds sponsored or promoted by Merrill Lynch or the AMEX.

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The Financial Sector Fund normally will invest at least 95% of its total assets in stocks that are represented in the index. The Fund may invest its remaining assets in money market instruments or funds which reinvest exclusively in money market instruments, in repurchase agreements, in stocks that are in the relevant market but not the relevant index, in convertible securities, structured notes (notes on which the amount of principal repayment and interest payment are based on the movement of one or more specified factors such as the movement of a particular stock or stock index), exchange traded stock index futures, exchange traded options on futures, stock or stock indexes as well as options on the shares. These investments may also be made temporarily to invest uncommitted cash balances or, in limited circumstances, to assist in meeting shareholder redemptions.

State Street, however, will purchase and maintain its position in the stock of securities-related issuers only in the approximate proportion that the stock represents in the relevant sector index. Under certain circumstances the Financial Sector Fund may adjust the number of shares of a component stock of the applicable sector index that is held in its portfolio, in order for the Fund to retain its status as a "regulated investment company" as defined in Subchapter M of the Internal Revenue Code. State Street will not make any such adjustment so as to reward any securities-related issuer for selling shares of a Fund. The composition of the Financial Sector Fund's portfolio securities will be adjusted periodically to conform to changes in its sector index resulting from corporate actions such as stock splits or changes in the identity of the index's component stocks. All adjustments to a Fund's portfolio in this regard will be non-discretionary.

Select Sector SPDR Fund shares are listed for trading on the AMEX. The shares will trade on the AMEX at prices based on a current bid/offer market, which may differ from the shares' net asset value. Each Select Sector SPDR Fund will issue and redeem shares, called Creation Units, at net asset value in exchange for the securities that comprise the Fund's sector index.<sup>2</sup> A Creation Unit is comprised of individually non-redeemable, exchange-traded shares called "SPDRs." State Street expects Fund shares to trade in the range of \$17 to \$30, and a Creation Unit's net asset value to range from \$850,000 to \$1,500,000.

### *Diamonds Trust*

The Diamonds Trust is a registered unit investment trust under the Investment Company Act. The Trust sponsor is PDR Services Corporation, a wholly-owned subsidiary of the AMEX. State Street serves as trustee of the Trust.

The investment objective of the Diamonds Trust is to provide investment results that correspond generally to the price and yield performance of publicly traded equity securities as represented by the DJIA, which consists of thirty stocks that are represented in equal share

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<sup>2</sup> The Select Sector SPDR Trust structure of an open-end investment company issuing non-redeemable exchange-traded shares is permitted by an SEC exemptive order. *The Select Sector SPDR Trust*, Investment Company Act Rel. No.s 23492 (Oct. 20, 1998) (Notice of Application) and 23534 (Nov. 13, 1998) (Order).

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amounts. Dow Jones & Co., Inc. is not affiliated with the Diamonds Trust or PDR Services Corporation, and has not participated, and will not participate, in the creation of the Diamond Trust or the selection of stocks purchased by the Diamonds Trust. The DJIA is the oldest continuous barometer of the U.S. stock market, and the most widely quoted indicator of U.S. stock market activity. The index consists of thirty stocks of companies that are all major leaders in their respective industries. The DJIA is a price-weighted stock index, which means the component stocks are represented in the same share amounts. The index is published by the *Wall Street Journal*. As of May 23, 2000, the issuers of the stocks in the index had a minimum individual market capitalization of \$14.4 billion, with an average of \$136.5 billion; their minimum daily trading volume was 674 thousand, with an average of 6.1 million. The stocks in the DJIA represent about a fifth of the \$8 trillion-plus market value of all U.S. stocks and about a fourth of the value of the stocks listed on the New York Stock Exchange.<sup>3</sup>

The Diamonds Trust utilizes an indexing approach in attempting to approximate the DJIA's investment performance. It holds a portfolio of securities consisting of all of the component common stocks of the DJIA in equal share amounts. The composition of the Diamonds Trust's portfolio securities will be adjusted periodically to conform to changes in the DJIA resulting from corporate actions such as stock splits or changes in the identity of the DJIA component stocks. All adjustments to the Diamonds Trust's portfolio in this regard will be non-discretionary. State Street will not substitute stocks that are not components of the DJIA for those that are, nor will it adjust the weighting of the DJIA stocks to deviate from the DJIA weighting.

Units of the Diamonds Trust are listed for trading on the AMEX. The units trade on the AMEX at prices based on a current bid/offer market, which may differ from the units' net asset value. The Trust issues and redeems units, at net asset value, called "Creation Units" in exchange for securities that comprise the DJIA.<sup>4</sup> A Creation Unit is comprised of individually non-redeemable, exchanged-traded units called "Diamonds." Trust Units have traded in the range of \$74 to \$94, and a Creation Unit's net asset value has ranged from \$3,700,000 to \$4,700,000.

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<sup>3</sup> "Dow Jones Industrial Average," "DJIA," and "DIAMONDS" are the property of Dow Jones & Company. The Diamonds Trust is permitted to use these marks pursuant to a licensing agreement with PDR Services Corporation (a subsidiary of the AMEX) and the AMEX. The Diamonds Trust, however, is not sponsored, endorsed, sold or promoted by Dow Jones.

<sup>4</sup> The Diamonds Trust structure of a unit investment trust issuing non-redeemable exchange-traded securities is allowed by an SEC order. *Diamonds Trust*, Investment Company Act Rel. Nos. 22927 (Dec. 5, 1997) (Notice of Application) and 22979 (Dec. 30, 1997) (Order).

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### *Investments in Securities-Related Issuers*

Some of the issuers represented in the S&P 500 and DJIA derive a substantial portion of their revenues from securities-related activities. The Index Funds, however, have investment objectives that require them to acquire securities of these issuers. These investments may implicate Section 12(d)(3).

The investment objective of the Financial Sector Fund is to provide investment results that correspond generally to the price and yield performance of the companies in the Financial Sector Index. The index consists of certain public companies that are components of the S&P 500 and are involved in the development and production of financial products. Companies in the index include a wide array of diversified financial service firms whose businesses range from investment management to commercial and investment banking.<sup>5</sup> Similarly, the Diamonds Trust holds in representative amounts of all the component common stocks in the DJIA, which includes issuers that derive a substantial portion of their revenue from securities-related activities.<sup>6</sup> These companies are generally financial service firms whose businesses range from investment management to commercial and investment banking.

### **Legal Analysis**

Section 12(d)(3), with limited exceptions, prohibits an investment company from acquiring any securities issued by a securities-related business, such as a broker, dealer, underwriter or investment adviser. "While the reasons for Congress prohibiting investment company investments in securities-related businesses are not addressed in much detail in the Act's legislative history, it appears that Congress had two purposes. First, Congress wished to limit, at least to some extent, the exposure of registered investment companies to the entrepreneurial risks peculiar to securities-related businesses." *Exemption of Acquisitions of Securities by Persons Engaged in Securities Related Businesses*. Investment Company Act Rel. No. 19204 (Jan. 4, 1993) (Proposing Amendments to Rule 12d3-1) [hereinafter RELEASE 19204]. "A second purpose appears to have been to prevent potential conflicts of interest and reciprocal practices." *Id.*<sup>7</sup>

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<sup>5</sup> Financial service firms currently represented in the S&P 500 and the Financial Sector Index include, among others: American Express Co.; Charles Schwab Corp.; Lehman Bros. Holdings Inc.; Merrill Lynch and Co., Inc.; Morgan Stanley Dean Witter & Co; and Citigroup, Inc.

<sup>6</sup> Financial service firms currently represented in the DJIA include, among others: American Express; J.P. Morgan & Company Inc.; and Citigroup, Inc.

<sup>7</sup> The Commission also has suggested that Congress had "apparent liquidity concerns" it sought to address by enacting Section 12(d)(3). *Exemption for Acquisition by Registered Investment Companies of Securities Issued by Persons Engaged Directly or Indirectly in Securities - Related Businesses*. Investment Company Act Rel. No. 13725 (Jan. 17, 1984)

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Rule 12d3-1, however, exempts some acquisitions from Section 12(d)(3). The Rule permits investment companies to acquire, among other securities, securities of a business "that, in its most recent fiscal year, derived more than 15% of its gross revenues from securities related activities" (a securities-related issuer) provided certain conditions are met. Rule 12d3-1(b). These conditions include subparagraph (b)(3)'s requirement that the investment company not invest more than 5% of its assets in securities of the securities-related issuer. The Index Funds are unable to comply with this 5% limitation; thus they may not rely on the Rule. The Index Funds may not invest in securities-related issuers to the extent that is necessary for them to track their respective indexes consistent with the limitations contained in a Section 12(d)(3) and Rule 12d3-1 because certain securities-related issuers comprise more than 5% of the Financial Sector Index and the DJIA. The Index Funds will comply with the Rule's other requirements as interpreted by the Division.

### *Entrepreneurial Risks*

In 1940, most securities-related issuers were organized as privately held general partnerships. By investing in these businesses, investment companies exposed themselves to potential losses that are not present in other types of investments; if a business failed, the investment company as a general partner was held accountable for the partnership's liabilities. RELEASE 19204, *supra*; *Investment Trusts and Investment Companies: Hearing before a Subcomm. of the Senate Comm. on Banking and Currency, 76th Cong., 3rd Sess. 243 (1940)* (testimony of David Schenker, Chief Counsel, Investment Trust Study).

The Commission has acknowledged that the concern regarding the unusual risks of investments in securities-related issuers "is adequately addressed by prohibiting the acquisition of general partnership interests." Paragraph (c) of Rule 12d3-1, which effectively precludes an investment company from acquiring general partnership interests in a broker, dealer, registered investment adviser, or underwriter adequately addresses Congress's concerns regarding an investment company's exposure to the entrepreneurial risks of investing in a securities-related issuer. Today, in any event, this concern is largely theoretical since virtually all securities firms are organized as corporations not general partnerships. See Anita Raghavan, *Why Is Goldman Sachs Seeking to Go Public? It's a Capital Question*, WALL ST. J. (Aug. 7, 1998) at A1 (noting that Goldman Sachs is Wall Street's last major private partnership).

### *Conflicts of Interest and Reciprocal Practices*

The 5% limitation of subparagraph (b)(3), as well as the Rule's other quantitative conditions, are designed to "minimize the potential for conflicts of interests and reciprocal practice by preventing an investment company from acquiring a significant stake in any

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(Adopting Amendments to Rule 12d3-1) [hereinafter RELEASE 13725]. To the extent liquidity is a Commission concern, the component stocks of the S&P 500 and the DJIA are some of the most liquid securities in the world — with an average daily trading volume of 1.4 million and 3.0 million, respectively.

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particular broker or dealer." RELEASE 19204, *supra*. The Index Funds' investments, as a practical matter, do not raise these concerns.

The Commission has been concerned, in particular, that an investment company might purchase the securities of a broker-dealer, not based on the merits of the investment, but as a reward for selling the investment company's shares. *Acquisition by Registered Investment Companies of the Equity Securities of Foreign Securities Firms*. Investment Company Act Rel. No. 17096, n.11 (Aug. 3, 1989) (Proposing Amendments to Rule 12d3-1).

The Index Funds' investment objectives and policies prevent them from purchasing securities of a broker-dealer as a reward for selling Index Fund securities. Since each Index Fund is an "index fund," the composition of its portfolio securities are essentially non-volitional.<sup>8</sup> Each Index Fund's investment objective is to replicate the relevant index or approximate the index performance. State Street, with extremely limited exceptions, does not have the discretion to choose portfolio securities of the amount purchased. State Street is obligated to follow a predetermined investment formula. It is permitted to deviate from the securities in an index to comply with requirements of the Internal Revenue Code, however, State Street anticipates that each Index Fund will hold all of the securities that comprise its benchmark index. State Street will not exercise investment discretion with respect to securities-related issuers, but will purchase the stock of a securities-related issuer and maintain its position in the stock in the same approximate proportion that the stock represents in the applicable index. The Financial Sector Fund's portfolio turnover is substantially less than that of investment companies that are not index funds because State Street manages the Fund's portfolio to track the applicable index. Thus, rewarding a broker-dealer for selling Index Fund securities is virtually impossible.

At the same time, it is highly unlikely that a broker-dealer would have any incentive to attempt to influence an Index Fund to purchase its shares. An Index Fund's purchase of securities of a particular broker-dealer represented in the S&P 500 or the DJIA would be *de minimus* in relation to the broker-dealer's market capitalization. It is extremely unlikely that these transactions would have any significant effect on the market value or profitability of a broker-dealer. Thus the incentive for a broker-dealer to exert influence in this regard is insignificant.

The Commission also has expressed its view that an investment company also might direct brokerage to a broker-dealer in which it had an investment to enhance the broker-dealer's profitability or to assist it in financial difficulty even if the broker-dealer did not offer best execution. RELEASE 3725, *supra*, n.9.

An Index Fund, as a practical matter, would be unable to direct brokerage either to reward a broker-dealer for selling the Fund's shares or to enhance the broker-dealer's

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<sup>8</sup> The Diamonds Trust, as a unit investment trust, is required by the Investment Company Act to hold a fixed portfolio of investment securities, with limited exceptions. Section 4(2) of the Investment Company Act.

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profitability. When selecting broker-dealers to handle the purchase and sale of portfolio securities, State Street's policy is to choose broker-dealers that obtain prompt execution of orders at favorable prices. State Street has an obligation, under the federal securities laws, to seek to obtain best execution in purchasing or selling the Index Fund's portfolio securities.

In addition, if the Diamonds Trust has invested more than 5% of the value of its total assets in the securities of a securities-related issuer, the Trust will not use that issuer, or any affiliated person of that issuer, as a broker for the purchase or sale of any security in the Trust's portfolio. Therefore, the Diamonds Trust would be unable to direct brokerage transactions to either enhance a broker-dealer's profitability or to assist the broker-dealer during financial difficulty. The Diamonds Trust, as a unit investment trust does not have a board of directors that could review the Trust's brokerage transactions in accordance with Section 17(e) of the Investment Company Act and Rule 17e-1.

If the Financial Sector Fund has invested more than 5% of the value of its total assets in the securities of a securities-related issuer, the Fund will comply with the provisions of Section 17(e) and Rule 17e-1 when using that issuer, or any affiliated person of that issuer, as a broker for the purchase or sale of any security in the Fund's portfolio. The Financial Sector Fund will comply with all of those provisions regardless of whether the securities-related issuer or any affiliated person of such an issuer is affiliated with the Financial Sector Fund. The Financial Sector Fund's compliance with those provisions in these circumstances would provide adequate safeguards against the reciprocal practices and conflicts of interest that Section 12(d)(3) was intended to address.

Moreover, any brokerage executed through a broker-dealer in the S&P 500 or DJIA would be *de minimus* in relation to the broker-dealer's trading activity. Due to the Financial Sector Fund's investment objective, it would be extremely unlikely that the amount of brokerage transactions that the fund could direct to any broker-dealer that is included in the S&P 500 would have any significant effect on the market value or profitability of the broker-dealer. Therefore, it is extremely unlikely that these transactions would have any meaningful effect on the market value or profitability of a broker-dealer. The Financial Sector Fund's portfolio turnover is substantially less than that of investment management companies that are not index funds because State Street manages the fund according to the indexing method described above. In addition, because the Index Funds only purchase and redeem their securities in Creation Units, the need for the Funds to trade portfolio securities and direct brokerage is greatly diminished. The amount of brokerage transactions resulting from purchase and redemption requests for Creation Units is greatly diminished because generally the shares of the Financial Sector Fund are purchased and redeemed in-kind. Based on the experience of similar products on the market, the vast majority of trading activity for the Index Funds will be with their

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- Each Index Fund will comply with its stated investment objectives and policies.
- Each Index Fund will purchase and maintain any position in a securities-related issuer only in the approximate proportion that the issuer's stock is represented in the relevant index except insofar as may be necessary for the Fund to retain its status as a regulated investment company as defined in Subchapter M of the International Revenue Code.<sup>12</sup>
- Each Index Fund will comply with all of the provisions of Rule 12d3-1 except subparagraph (b)(3).
- If the Financial Sector Fund has invested more than 5% of the value of its total assets in the securities of a securities-related issuer, the Fund will comply with the provisions of Section 17(e) and Rule 17e-1 when using that issuer, or any affiliated person of that issuer, as a broker for the purchase or sale of any security in the Fund's portfolio.
- If the Diamonds Trust has invested more than 5% of the value of its total assets in the securities of a securities-related issuer, the Trust will not use that issuer, or any affiliated person of that issuer, as a broker for the purchase or sale of any security in the Trust's portfolio.

Here, we are requesting that the Division provide no-action assurances regarding a provision of the Rule that raises few concerns, with investments that are structured with sound safeguards.

In the past, the Commission has issued exemptive orders to permit open-end investment company and unit investment trust "index funds" to acquire stock of a securities-related issuer under certain conditions. *See, e.g., PFL Endeavor Target Account*, Investment Company Act Rel. No.s 23241 (June 5, 1998) (Notice of Application) and 23298 (July 1, 1998) (Order); *John Nuveen & Co. Inc.*, Investment Company Act Rel. No.s 22492 (Feb. 4, 1997) (Notice of Application) and 22545 (Mar. 5, 1997) (Order). We believe that substantially similar safeguards are presented with the structure of the Index Funds' investments. In addition, in light of the no-action positions the Division has taken regarding subparagraph (c) of Rule 12d3-1, we believe that the Division should reach the conclusion that no-action assurances are appropriate here.

The Commission has acknowledged that while Section 12(d)(3) "may have been designed to protect investment companies . . . , evidence indicates that today the Section often prevents investment companies from making investments that may be in the best interests of their shareholders." RELEASE 13725, *supra*. We believe that the Index Funds' investments are in the best interests of Fund shareholders. We also believe that the investments, as structured,

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<sup>12</sup> The Financial Sector Fund will not direct brokerage transactions to enhance a broker-dealer's profitability or assist a broker-dealer during financial difficulty.

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are consistent with the provisions of Section 12(d)(3). Accordingly, we request that the Division provide assurances that it will not recommend any enforcement action to the Commission, as requested in this letter.

If you have any questions regarding this letter, please contact Robert A. Robertson at (212) 506-2538 or me at (212) 506-2695.

Very truly yours,



Stuart M. Strauss