

Investment Management Regulation

The Investment Management Division regulates investment companies (which include mutual funds, closed-end funds and unit investment trusts) and investment advisers under two companion statutes, the Investment Company Act of 1940 and the Investment Advisers Act of 1940. The Division also administers the Public Utility Holding Company Act of 1935. The Division's goal is to minimize financial risks to investors from fraud, self-dealing, and misleading or incomplete disclosure.

What We Did

- Adopted amendments that enhance the independence and effectiveness of mutual fund directors, strengthen fund directors' ability to deal with fund management, and reinforce director independence. The amended rules also require funds to provide better information about directors to their shareholders.
- Adopted amendments requiring mutual funds to disclose standardized after-tax returns for 1-, 5-, and 10-year periods to help investors understand the magnitude of tax costs and compare the impact of taxes on the performance of different funds.
- Adopted a new rule that requires a registered investment company with a name suggesting that the company focuses on a particular type of investment to invest at least 80% of its assets in the type of investment suggested by its name.

- Launched the Investment Adviser Public Disclosure website, which provides public access to background, business, and disciplinary information about registered investment advisers.
 - Issued a staff report on mutual fund fees that describes trends in mutual fund fees between 1979 and 1999; identifies some of the major factors that influence the amount of fees charged; and recommends future actions by the Commission in the areas of disclosure, mutual fund governance, and investor education.
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Significant Investment Company Act Developments

As stock prices retreated from record highs set in 2000, total assets managed by investment companies declined approximately \$400 billion to a total of \$7 trillion as of September 30, 2001. This \$7 trillion was managed in 34,312 investment company portfolios sponsored by 1,075 investment company complexes. Despite the decline in investment company assets under management (the first since 1977), investment companies still manage more than twice the amount of money on deposit at commercial banks (\$3.4 trillion) and more than the amount of financial assets at commercial banks (\$6.3 trillion). Open-end management investment companies, commonly known as mutual funds, are the largest segment of the investment company industry. Over 50 million U.S. households, about 52% of all U.S. households, own mutual fund shares.

Rulemaking

Independent Directors

The Commission adopted a package of rules and form amendments under the Investment Company Act to enhance the independence and effectiveness of mutual fund directors, strengthen fund

directors' ability to deal with fund management and reinforce director independence.⁶⁸ The amendments reflect many suggestions made during a roundtable to discuss the role of fund independent directors held by the Commission in 1999. For funds relying on certain exemptive rules under the Investment Company Act, the amended rules require that: (1) independent directors constitute a majority of the fund's board; (2) independent directors select and nominate other independent directors; and (3) any legal counsel for the independent directors be an independent legal counsel. The amended rules also require funds to provide better information about directors to their shareholders, including basic information about the identity and experience of directors, fund shares owned by directors, information about directors that may raise conflict of interest concerns, and information about the board's role in governing the fund.

After-Tax Returns

A mutual fund's trading practices and investment strategies affect the amount of taxes that investors must pay on fund profits. To help investors understand the magnitude of tax costs and compare the impact of taxes on the performance of different funds, the Commission adopted rule amendments that require mutual funds to disclose standardized after-tax returns for 1-, 5-, and 10-year periods.⁶⁹ After-tax returns must accompany before-tax returns in a fund's prospectus and be presented two ways: (1) returns after taxes on fund distributions only; and (2) returns after taxes on fund distributions and a redemption of fund shares. The amendments also require funds to include standardized after-tax returns in certain advertisements and other sales materials. The original compliance date for advertisements and sales materials was October 1, 2001, but was extended to December 1, 2001. The compliance date for prospectuses is February 15, 2001.

Investment Company Names

The Commission adopted a new rule to address certain broad categories of investment company names that are likely to mislead investors about an investment company's investments and risks.⁷⁰

The rule requires a registered investment company with a name suggesting that the company focuses on a particular type of investment to invest at least 80% of its assets in the type of investment suggested by its name. The rule also applies to names suggesting that an investment company focuses its investments in a particular country or geographic region, names indicating that a company's distributions are exempt from income tax, and names suggesting that a company or its shares are guaranteed or approved by the United States Government.

Electronic Recordkeeping

The Commission amended its rules to permit registered investment companies to preserve required records using electronic storage media such as magnetic disks, tape, and other digital storage media.⁷¹ The amendments respond to the Electronic Signatures in Global and National Commerce Act (E-SIGN), which encourages federal agencies to accommodate electronic recordkeeping.

Treatment of Repurchase Agreements

The Commission adopted a new rule and related rule amendments to enable investment companies to invest in certain types of repurchase agreements and pre-refunded bonds without causing technical violations of the rules requiring fund diversification or prohibiting investments in brokers, dealers, or underwriters. The new rule permits investment companies to look through counterparties to certain repurchase agreements and issuers of municipal bonds that have been refunded with U.S. Government securities and treat the securities comprising the collateral as

investments for certain purposes under the Investment Company Act.⁷²

Affiliated Transactions

The Commission proposed amendments to rule 10f-3 under the Investment Company Act that would expand the exemption provided by the rule to permit registered investment companies to purchase government securities during the existence of an underwriting syndicate for those securities when an affiliate of the investment company participates in the syndicate. The proposed amendments also would modify the rule's quantitative limit on purchases, to cover purchases by a fund as well as any account advised by the fund's investment adviser. The amendments are intended to respond to changes in the method of offering certain government securities and to improve the effectiveness of the quantitative limit on fund purchases.⁷³

Portfolio Investment Programs

The Commission denied the Investment Company Institute's rulemaking petition to regulate portfolio investment programs sponsored by broker-dealers and investment advisers under the Investment Company Act.⁷⁴ Investors participating in these programs typically use the sponsor's website to create personalized portfolios (also referred to as baskets) of securities. In the denial letter, the Commission contrasted the characteristics of an investment company with those of the portfolio investment programs and pointed out that sponsors of portfolio investment programs generally are subject to regulation and oversight under the Securities Exchange Act of 1934 and, in some cases, under the Investment Advisers Act. The Commission stated that it will monitor the development of these programs to assure that they are appropriately regulated under the federal securities laws.

Exemptive Orders

The Commission issued 293 exemptive orders to investment companies (other than insurance company separate accounts) seeking relief from various provisions of the Investment Company Act. The Commission also issued 51 exemptive orders to investment companies that are insurance company separate accounts. Some of the significant exemptive orders that the Commission issued in fiscal 2001 are discussed below.

Shareholder Approval of Subadvisory Contracts

The Commission issued an order denying a request for a hearing and granting an exemption to permit certain investment companies operating with a “manager of managers” structure to enter into, and materially amend, subadvisory agreements without shareholder approval.⁷⁵

Affiliated Transactions

The Commission issued an order permitting certain money market funds to engage in principal transactions in certain tax-exempt money market instruments with an affiliated dealer.⁷⁶ The Commission also issued an order permitting various types of transactions for certain investment companies that became prohibited as a result of an affiliation created by a joint venture between two financial services companies.⁷⁷ In addition, the Commission issued an order permitting certain investment companies to purchase securities through group orders when an affiliated broker-dealer is a member of the underwriting syndicate.⁷⁸

Employee Securities Companies

The Commission issued an order exempting certain employee securities companies, offered to employees who are accredited

investors or in reliance on rule 701 under the Securities Act of 1933, from various provisions of the Investment Company Act.⁷⁹

Orders Addressing Events of September 11, 2001

On September 14, 2001, the Commission issued a temporary order providing investment companies greater borrowing and lending flexibility.⁸⁰ The Commission subsequently issued an order extending this temporary order.⁸¹ The Commission also temporarily exempted investment companies from the in-person meeting and voting requirements for directors under the Investment Company Act.

Interpretive and No-Action Letters and Reports

The staff issued 43 interpretive and no action letters and reports during fiscal 2001. Some of the most significant Investment Company Act guidance that the Division issued in fiscal 2001 are discussed below.

Valuation

The staff provided interpretive guidance to mutual funds and their directors regarding their obligation to determine the fair value of funds' portfolio securities when market quotations for those securities are not readily available. The staff also reiterated: (1) the Commission's position on when market quotations may not be readily available; (2) certain circumstances under which funds should analyze whether market quotations are readily available; and (3) the obligation of fund boards to determine the fair value of funds' portfolio securities in good faith.⁸²

Mutual Fund Fees

The staff released a report on trends in mutual fund fees from 1979 to 1999.⁸³ The report:

- describes the legal framework with respect to mutual fund fees,
- analyzes how fees have changed over time,
- identifies factors that may influence the current level of fees,
- recommends initiatives that are designed to improve the corporate governance structure for the oversight of fund fees and the disclosure that investors receive regarding fees, and
- addresses a recommendation by the General Accounting Office (GAO) to require individual disclosure in account statements of the dollar amount of fund fees paid by investors by:
 - agreeing with the GAO that investors need clear and understandable information about the fees that they pay and that the fund industry and the Commission should encourage fund shareholders to pay greater attention to fees and expenses, and
 - suggesting an alternative approach in which the dollar amount of actual fees paid by investors would be disclosed in semi-annual and annual shareholder reports by calculating a hypothetical investment amount and the fund's actual returns.

Variable Annuity Exchange Offers

The staff provided guidance regarding the applicability of the “retail exception” under section 11 of the Investment Company Act when variable annuity contracts issued by an insurance company are exchanged for other contracts issued by the same insurance company. The staff identified factors appropriate for consideration

when analyzing whether an exchange offer falls within the retail exception, but cautioned that whether an exchange offer falls within the retail exception cannot be determined by the application of a bright line test.⁸⁴

Inadvertent Investment Companies

The staff stated that it would not recommend to the Commission an enforcement action under section 7(a) of the Investment Company Act against an issuer if the issuer fails to register as an investment company when the issuer meets the definition of investment company set forth in section 3(a)(1)(C) of the act and rule 3a-1 thereunder as a result of its holdings of shares of money market funds.⁸⁵

Private Investment Companies

The staff stated that it would not recommend enforcement action to the Commission under section 7(a) of the Investment Company Act if issuers that are excluded from the definition of investment company by section 3(c)(1) or 3(c)(7) of the act do not register as investment companies when, under certain circumstances, a participant-directed employee benefit plan invests in securities issued by the issuers.⁸⁶

Tracking Stock

The staff concluded that an operating company's issuance of tracking stock to track the performance of a business group within the company generally would not render the tracked business group a separate "issuer" under the Investment Company Act and hence would not subject the business group to registration and regulation under the act. The staff also provided guidance as to the circumstances under which a tracked business group could be deemed to be a separate issuer and an investment company under the Act.⁸⁷

Redemption Fees

The staff stated that, subject to certain conditions, it would not recommend enforcement action under various sections of the Investment Company Act if, upon the reorganization of a closed-end fund into an open-end fund, the new open-end fund imposed a temporary redemption fee of 4% on redemptions by certain of the new open-end fund shareholders. The staff also summarized the circumstances under which an open-end fund generally may impose a redemption fee of no greater than 2%.⁸⁸

Accumulation Unit Tables In Variable Annuity Prospectuses

The staff stated that it would not recommend enforcement action if the prospectus for certain variable annuity contracts includes the accumulation unit value tables required by Item 4(a) of Form N-4 only with respect to the classes of accumulation units corresponding to the highest and lowest combination of charges available under the contract, provided that tables for all other classes of accumulation units available under the contracts, corresponding to all other possible combinations of contract charges, are contained in the Statement of Additional Information.⁸⁹

Significant Investment Advisers Act Developments

As of September 30, 2001, 7,100 investment advisers were registered with the SEC. These advisers had assets under management of approximately \$20 trillion.

Rulemaking

Electronic Recordkeeping

The Commission adopted amendments to rules under the Investment Advisers Act that allow investment advisers to preserve

required records using electronic storage media such as magnetic disks, tape and other digital storage media in the same manner as adopted for investment companies.⁹⁰

Other

New Public Website

As an outgrowth of the new electronic registration system (the Investment Adviser Registration Depository or IARD), the Commission launched a new website (www.adviserinfo.sec.gov) through which investors have free access to the current registration statement filed by an investment adviser. By visiting the website, prospective clients can obtain current information about an adviser's background, fees, business practices and any disciplinary history.

Significant Public Utility Holding Company Act Developments

Developments in Holding Company Regulation

The trend towards consolidation of utility company systems continued, resulting in an increase in the number of proposed mergers and acquisitions considered by the Commission. As a result of these mergers and acquisitions, the Commission approved 11 new registered holding companies in fiscal 2001. In addition, utility holding company systems continued to show interest in investing in non-utility activities, both domestic and foreign, particularly in the area of electrical contracting and infrastructure services.

Registered Holding Companies

As of September 30, 2001, there were 34 public utility holding companies and 29 public utility holding company systems

registered under the Holding Company Act. The registered systems were comprised of 133 public utility subsidiaries, 98 exempt wholesale generators, 185 foreign utility companies, 2,472 nonutility subsidiaries and 402 inactive subsidiaries, for a total of 3,324 companies and systems with utility operations in 44 states. These holding company systems had aggregate assets of approximately \$417 billion and operating revenues of approximately \$173 billion for the period ended September 30, 2001.

Financing Authorizations

The Commission authorized registered holding company systems to issue approximately \$76.5 billion of securities, an increase of approximately 330% over last year. The financing authorizations included transactions totaling \$14.7 billion for investments in exempt wholesale generators and foreign utility companies.

Examinations

The staff conducted examinations of 3 service companies, 3 parent holding companies and 9 special purpose corporations. The examinations focused on the methods of allocating costs of services and goods shared by associate companies, internal controls, cost determination procedures, accounting and billing policies and quarterly and annual reports of the registered holding company systems. By identifying misallocated expenses and inefficiencies through the examination process, the SEC's activities resulted in savings to consumers of approximately \$30 million.

Orders

The Commission issued 76 orders under the Holding Company Act. Some of the more significant orders are described below.

Exelon Corporation

The Commission authorized Exelon Corporation to acquire all of the issued and outstanding common stock of PECO Energy Corporation following the merger of Unicom Corporation, an exempt holding company whose principal public utility is Commonwealth Edison Company, with Exelon. Subsequently, Exelon registered under section 5 of the Holding Company Act.⁹¹

CP&L Energy, Inc.

The Commission authorized CP&L Energy, Inc., a public utility holding company claiming exemption under the Holding Company Act, to acquire directly all issued and outstanding stock of Florida Progress Corporation, a holding company also claiming exemption under the Holding Company Act. Subsequently, the newly formed holding company, Progress Energy, registered under section 5 of the Holding Company Act.⁹²

The AES Corporation

The Commission authorized The AES Corporation, a Delaware public utility holding company exempt from registration by order under the Holding Company Act, to acquire all of the outstanding voting securities of IPALCO Enterprises, Inc., a holding company also exempt from registration under the Holding Company Act. The Commission issued an order exempting registration under the Holding Company Act conditioned upon AES' divestiture of certain interests within two years of the date of consummation of the acquisition.⁹³

Rulemaking

Foreign Utility Companies

The Commission re-proposed and sought further public comments on rules 55 and 56 and an amendment to rule 87 under the Holding

Company Act. The proposal generally requests comments on possible limitations upon the ability of a holding company to qualify foreign operations as a foreign utility company. The rulemaking is intended to carry out Congress' mandate to adopt rules concerning acquisitions of foreign utility companies by registered holding companies.⁹⁴

Electronic Recordkeeping

The Commission proposed and amended rule 1 under the Holding Company Act. The amendment addresses the maintenance of records by registered holding companies and their mutual or subsidiary service companies as required by rule 26 under the Holding Company Act.⁹⁵ The amendment expanded companies' ability to use electronic storage media, such as magnetic disks and tape, to maintain and preserve records, provided specified record maintenance procedures are followed. The Commission amended rule 1 in response to the passage of E-SIGN, which encourages federal agencies to accommodate electronic recordkeeping.