Investment Management Division ✓

MEMORANDUM

January 27, 1978

TO : Chairman Williams

FROM : Sydney H. Mendelsohn, Acting Director
Division of Investment Management

SUBJECT : Review and Administration of the Investment Company Act

During our discussion the other evening, you raised a number of significant points about the Investment Company Act and its administration. After reflection I would like to elaborate on some of the thoughts I expressed about the virtues of the Act, proper administration of the Act, and the best way to consider whether any major revisions of the Act are needed.

It is certainly true that the Investment Company Act greatly restricts and regulates the business operations of investment companies. It has been said that the Act is like the German Civil Code; everthing is prohibited unless permitted. However, the genius of the Act is that it is flexible enough to permit the Commission to allow broad variations from the regulatory pattern when it is appropriate to do so. 1/ Consequently, whatever one's view of the proper scope of regulation, an evaluation of how the Act is working depends to a large degree on how it is being administered by the Commission and this Division.

In the past year we have identified certain problems with the way in which the two '40 Acts have been interpreted and administered and I have supported and encouraged programs for improvement.

1/ Section 6(c) of the Act authorizes rules and orders granting exemption from any provision of the Act if the Commission finds the exemption necessary or appropriate in the public interest and consistent with the protection of investors and the purposes of the Act.

Firstly, there had been no methods by which applications were reviewed to determine whether selective rules could be adopted to avoid the necessity for recurring applications. Such a review (which is being regularized) was done last year and two rules were proposed which dealt with some of the most frequent forms of application. 2/

Secondly, there had been no real attempt to monitor processing of "no-action" letters, either to spot slowness of response or to seek to establish, by memorandum, release or rule, divisional or Commission positions designed to deal with recurrent matters of inquiry or "hang-ups" which in effect slowed response. A monthly review of unanswered letters has only recently been introduced, and should be continued and perfected. The proposed referral fee rule is an example of a result of this type of review.

Thirdly, discrete requirements have been examined on a cost-benefit approach: an example is the removal of the S-4 and S-5 guidelines requirement that a shareholder vote on advisory contracts for new management companies be taken within 90 days of their commencement, substituting a requirement that such vote be held at the first regularly scheduled meeting.

Fourthly, relatively "exotic" interpretations of the law have been taken over the years, which are hard to justify on legal grounds. We have begun to take interpretative positions only when we believe in case of court action our position would stand a reasonable chance of being sustained. There has been more than one change of position as a consequence (e.g., the publishing of a single book no longer requires investment adviser registration).

Fifthly, rules have been "floated", but then left as proposals neither having been adopted nor withdrawn. This tends to cast doubt on certain activities covered thereby, and certainly, past a point is not useful. The proposed "service contract" rule under Section 17 is an example of this: proposed in 1974 and nothing done since. We intend to have a proposal to the Commission shortly.

2/ These are Rule 2a-5, which exempts certain persons from the definition of an "interested person" in Section 2(a)(19) of the Act, and proposed Rule 8f-1, which, when adopted, will replace applications for deregistration with a form.

Sixthly, I believe we have an excellent liaison with the regional offices and the Division of Enforcement. Nevertheless, we can continue to improve our inspection program and our coordination in the area of enforcement. To this end I will recommend the re-establishing of a special counsel in the division to be specifically responsible for such liaison and coordination.

Lastly, there is, I believe, a need for staff members to be more familiar with the actual operation of mutual funds, so that their actions will bear some resemblance to reality. We plan more inspection visits by home-office staff members for this purpose. We have also instituted in the last year a rotation In addition, I question whether too much review of work has been at the Director level, and whether lower levels could not reasonably be expected to be given some greater latitude within limits. This I believe would boost morale by giving responsibility to those who are willing and able to assume it.

Of course, we face a set of problems under the Advisers Act different from the Investment Company Act, partly because we know so much less about the industry we are dealing with. As you know, the Commission has proposed the so-called brochure rule and corresponding amendments of the Form ADV registration form for advisers. The changes, if adopted, would require advisers to furnish disclosure statements to clients and prospective clients and would also provide the Commission and the public with much more information than is now available about the advisory business. To further this end and to tighten our regulatory effectiveness, I will recommend that we establish the position of special counsel. I envision that such function will develop into a new Office of Investment Advisers headed by an assistant director.

None of the above, singly, is particularly dramatic. Yet, if pursued, I believe that a not insignificant improvement can be made in the regulation of investment companies and investment advisers, in the near future, and at little incremental cost.

In addition to these management improvements, we have begun to take fuller advantage of the flexibility given by Section 6(c) and other exemptive provisions of the Act. I do not want to

make this discussion too long, but I do think I should back up my general assertion with a few examples. Not too long ago Merrill Lynch came in with a problem under Section 10(f) of the Act, arising from the recent and significant advent of managed municipal bond funds. 3/ Section 10(f) would normally operate to prevent the Merrill Lynch Municipal Bond Fund, Inc. from purchasing municipal bonds in an underwriting if Merrill Lynch was a principal underwriter. Since Merrill Lynch participates in so many municipal bond offerings, the Section 10(f) prohibition seriously limited the Fund's ability to purchase new issues. Through the negotiation process we always follow in difficult applications, we were able to agree on conditions under which an exemption could be granted. As a result, something which the statute flatly prohibits -- and for good reason in view of the potential for dumping -- was permitted. Other recent examples with which you are somewhat familiar are the application of the Vanguard group to permit the funds to bear distribution expenses under certain circumstances and the applications by a number of money market funds for exemption, subject to conditions, from our interpretation on portfolio valuation. Although neither of these two matters is by any means resolved, I believe they demonstrate our willingness to confront difficult issues without retreating into a restrictive shell.

Although the applications discussed in the previous paragraph present widely differing problems, the solutions, actual and proposed, have a notable common theme: emphasis on the role of the directors, particularly the disinterested directors. As you know, our proposals in the area of funds bearing distribution expenses, contain a similar emphasis. This represents a striking change in attitude. In the past, the Commission and the courts have with justification been reluctant to place too much faith in the disinterested directors. However, judicial attitudes in this area have been changing to place more reliance on the

---

3/ Section 10(f) generally speaking prohibits investment companies from purchasing securities in an underwriting if a principal underwriter of the securities is an affiliated person of the investment company.

actions of fund directors, 4/ and I think it proper that our thinking continue to evolve in that direction as well. Future regulation should look to disinterested directors, properly informed and acting in a manner consistent with their fiduciary duties, for business decisions. If they fail in particular cases to fulfill their responsibilities, enforcement is the answer. If our experience shows that they are generally unable to live up to their responsibilities, we will have learned something very valuable: that one of the Act's fundamental notions is fallacious. If, on the other hand, directors are able to live up to expectations, both the public and the Commission will benefit.

Of course, we make no claims to perfection, and we may be justifiably accused in some cases of over-regulation or inflexible regulation. I know from our discussions that you are concerned that our proposed Rule 17f-4 regulating use of depositories by funds may be a case of overly detailed regulation. I assure you I have taken your message seriously although I continue to believe that the investment company industry basically likes to be given detailed guidance in matters of this sort. Nevertheless, I have informed the staff of the Commission's concern in this area.

There is one other point we discussed I would like to elaborate on; that is the possibility of significant revision of the Act. My basic belief is that such an effort should be conducted by a separate staff acting independently, but with the ability to call on divisional personnel for assistance and discussion.

4/ Tannenbaum v. Zeller is a good example. However, see the recent (January 11) decision of the Second Circuit in Lasker v. Burks reversing a district court decision that a fund's independent directors could in the exercise of their business judgment dismiss a derivative suit. The impact of the case may be somewhat limited in view of the facts. The court viewed the disinterested directors as colleagues of persons who might be liable in the case and expressed concern that they might not be able to act objectively in those circumstances.

The question, of course, of whether to conduct such a study appears to me to be one of cost-benefit considered in light of other activities of this Commission in the near future, including a careful inquiry into the political feasibility of enacting recommendations resulting from such a study. A copy of a division proposal, setting forth a budget request in this regard, is attached. I believe the projected requirements to be reasonably accurate.

The important matter to me is the structure of such an inquiry. 5/ To me, the approach of constituting an independent staff is the critical point. Firstly, it would assume a certain independence of view, less bound to defense of past positions. Secondly, it allows for appropriate cost control, difficult if the activity is blended with other activities of the division. Thirdly, it would avoid conflict with the ongoing administration of the statute recognizing the difficulty of enforcing statutory provisions if it is known the self-same people are recommending sharp change (we have seen this in the advertising area).

5/ The study could take at least two forms: (a) assuming the coverage of the Act remains about the same (investment companies), how can it be improved (greater responsibility to independent directors, greater reliance on disclosure, etc.) or (b) an attempt to integrate all forms of "money management" (bank and pension funds, oil and gas funds, REITS, etc.) under a single scheme.

Prior to the budget submission, both approaches were outlined internally. The principal problems relating to approach (b) relate to (i) political feasibility in the near future, (ii) substantive differences among the various areas despite an initial seeming similarity and (iii) lack of present theoretical economic basis for which a consensus could be developed for uniform treatment.

The staff is prepared to speak to the pros and cons. The main point I would make is that the decision to undertake such a study should be made after discussion of the pros and cons. I believe it could be decided either way, based on an evaluation against the other near-term needs of the Commission.

Finally, experience has shown that the better studies have been performed by a separate staff; and when the activities of study and normal administration are blended, the study suffers, because day-to-day "emergencies" tend to inevitably pull people away from study activities.

To summarize, I believe by far the best approach to such an inquiry is that of a separate staff, headed by a capable person which would act on its own but consulting as it deems necessary with divisional personnel. I further believe the regular staff of the division should be given the chance to review and comment on the results of such a study before it was submitted to the Commission.

The foregoing is a rather informal statement of views. Naturally, I will be happy to expand upon any of these ideas if you are interested in pursuing them.