Chapter 12

Affiliated Transactions

I. Introduction and Summary of Recommendations

Several provisions of the Investment Company Act[1] restrict transactions involving investment companies and their affiliates. Most notably, section 17[2] prohibits or restricts a wide range of affiliated transactions, and section 10(f)[3] limits an investment company's acquisition of securities from an underwriting syndicate containing certain affiliates. The restrictions on affiliated transactions were enacted in 1940 in response to a wide array of abuses that occurred in the 1920's and 1930's. The Division has concluded that these restrictions remain sound and should be preserved in all critical respects. For more than fifty years they have played a vital role in protecting the interests of shareholders and in preserving the industry's reputation for integrity; they continue to be among the most important of the Act's many protections.

The breadth of some of these provisions, however, prohibits some transactions that do not involve the concerns the provisions are intended to address, and the process of applying for exemptive relief can impose delays and costs upon investment companies and may deter them from pursuing beneficial investments. Accordingly, the Division recommends rulemaking proceedings to narrow the prohibitions on affiliated transactions in certain limited areas where current prohibitions can be relaxed without reducing the protection of investment companies and their shareholders.

In particular, the restrictions in section 17(d) and rule 17d-1[4] on a particular form of affiliated transaction, the "joint" transaction, unduly inhibit some types of transactions that pose little risk of conflict of interest. The Division therefore recommends that the Commission broaden the classes of transactions currently permitted in two areas. First, the Division recommends allowing directors of investment companies to authorize joint transactions with remote affiliates, rather than requiring that such transactions be reviewed by the Commission. The Division does not, however, recommend allowing directors to

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[1]Investment Company Act of 1940, 15 U.S.C. § 80a.

[2]15 U.S.C. § 80a-17.

[3]15 U.S.C. § 80a-10(f).

[4]17 C.F.R. § 270.17d-1.

approve other affiliated transactions such as principal transactions or transactions with closer affiliates, because such other transactions present greater risks of conflicts of interest. Second, the Division recommends exempting joint transactions where an investment company and its affiliates participate on the same terms, except to the extent of their participation.

In addition, the Division recommends that the Commission revise rule 10f-3 to permit investment companies to purchase securities in foreign markets in underwritings involving affiliates. That rule currently exempts certain transactions from the Act's prohibition on investment company purchases from an underwriting syndicate that includes an affiliate, but in practice the exemption does not reach transactions involving foreign offerings.

This chapter begins by describing the current regulatory framework governing affiliated transactions. It then discusses briefly how that framework has been altered for business development companies. Finally, it analyzes the various options for reform considered by the Division and sets forth the Division's recommendations.

11. Current Regulation of Affiliated Transactions Under the Investment Company Act

The Investment Company Act's provisions concerning affiliated transactions were enacted in response to the Commission's exhaustive report on the investment company industry. The Investment Trust Study described in great detail numerous instances of overreaching and self-dealing by investment company insiders. The Commission found that:

> [s]ponsors, in their capacity as sellers of securities to and purchasers of securities from investment companies, perpetrated many abuses. They not only sold securities to investment companies to realize profits as principal[s] or commissions as brokers, but also sold securities to these companies for a variety of other reasons. For example, "dumping" (selling to a controlled investment company securities which are otherwise unmarketable at the sale price) was very common. Also, the sponsors frequently sold securities to their investment companies in order to secure, facilitate, or maintain control of the portfolio companies, or to aid in

mergers, consolidations, or other objectives of [the] sponsors. Sales were also made to investment companies by sponsors to secure various indirect benefits?

The resulting regulatory framework included restrictions on transactions involving investment companies and their affiliates. These are summarized below.

A. Investment Companies

1. Affiliation under the Act

The Act's restrictions apply to transactions with persons having various degrees of affiliation with an investment company. For example, the affiliates subject to section 17(a) include any affiliated person[6] or promoter of or principal underwriter for a registered investment company (a "first tier" affiliate), or any affiliated person of such a person, promoter, or underwriter (a "second tier" affiliate)[7]. Other provisions of the Act apply to transactions with slightly different combinations of affiliates.

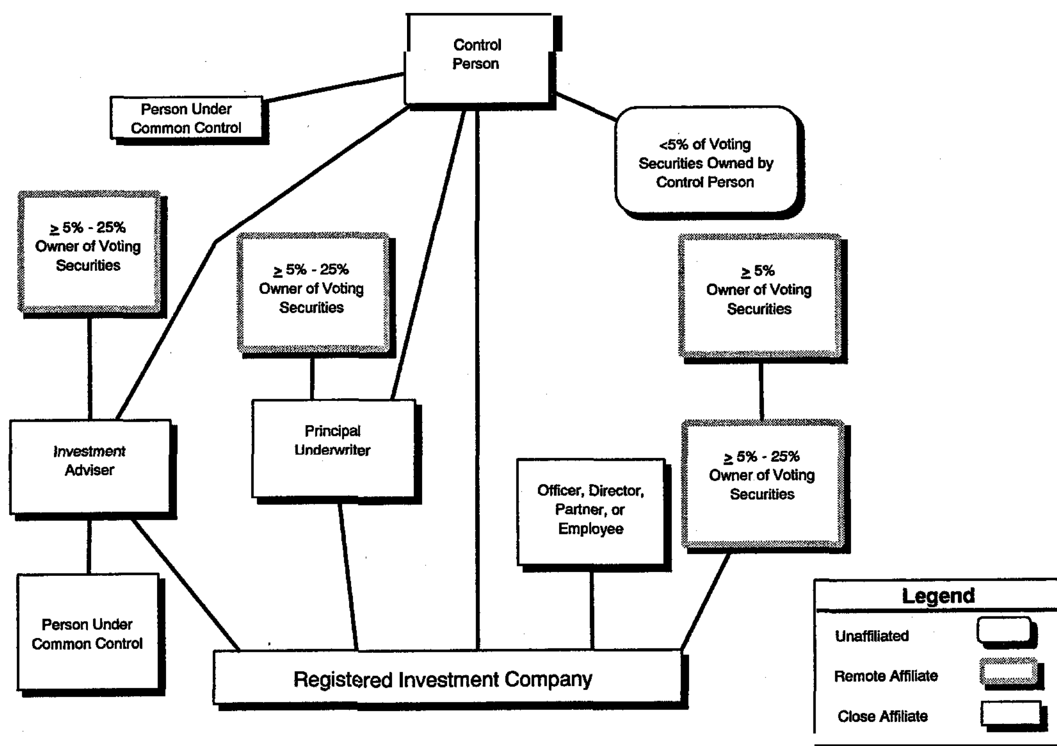
[5]SEC, INVESTMENT TRUSTS *AND* INVESTMENT COMPANIES, PT. 3, H.R. Doc. No. 136, 77th Cong., 1st Sess., at 2581 (1939) [hereinafter INVESTMENT TRUST STUDY]. The Commission devoted over 200 pages of the Investment Trust Study to the discussion of specific instances of overreaching by affiliates in connection with the purchase and sale of portfolio securities, loans by investment companies, and investments in related investment companies. Id. at 2581-2793.

[6]Section 2(a)(3) defines an "affiliated person" of an investment company to include any person owning five percent or more of the investment company's voting securities; any person in which the investment company owns five percent of more of the voting securities; any person directly or indirectly controlling, controlled by, or under common control with, the investment company; any of the company's officers, directors, partners, or employees; the investment adviser and any members of an advisory board; and, in the case of a unit investment trust, the depositor. 15 U.S.C. § 80a-2(a)(3). For the sake of brevity, this chapter uses the term "affiliate" when referring to persons subject to sections 10(f), 17(a), and 17(d) of the Act and rule 17d-1 thereunder.

[7]These sets of affiliated relationships are referred to as "tiers" for convenience. In fact, each of these tiers often consists of intricate, multi-leveled sets of entities that are directly or indirectly under common control.

Figure 12-1, below, depicts certain registered investment company upstream affiliated relationships.

FIGURE 12-1
Upstream Affiliations



The depictions in Figure 12-1 include one entity that is "unaffiliated" with the investment company (see Legend); transactions between this entity and the investment company are outside of section **17's** scope. Six of the depicted entities, on the other hand, are close affiliates of the investment company; transactions between these entities and the investment company generally must be approved by the Commission. Four of the depicted entities are remote affiliates of the investment company. Under the terms of the Division's proposed amendments to rule 17d-1, discussed below, the investment company could engage in certain joint transactions with these remote affiliates if approved by the company's board of directors, rather than the Commission.

2. Section 17(a)

Section 17(a) makes it unlawful for any first or second tier affiliate of a registered investment company (1) knowingly to sell securities or property to the company; (2) knowingly to purchase securities or property from the company; or (3) to borrow money or property from the company. Thus, section 17(a) prohibits transactions with first or second tier affiliates and applies only where the affiliate is acting as principal[8] (Section 17(e), discussed below, applies to agency transactions.) Under section 17(b), the Commission, upon application, shall exempt a proposed transaction from section 17(a) if it finds that the proposed transaction is reasonable and fair and does not involve overreaching, is consistent with the policy of the company, and is consistent with the general purposes of the Act?

Under section 6(c),[10] the Commission has adopted eight rules exempting from section 17(a) certain classes of affiliated transactions that otherwise would require Commission exemptive orders. For example, rule 17a-7 permits funds that are affiliated persons solely by virtue of having common or related advisers, common directors, and/or common officers, to sell securities at market prices to each other, subject to certain conditions, one of which requires a form of director review. A fund's board, including a majority of the "independent" directors,[11] must adopt procedures that are reasonably designed to provide for compliance with the other conditions in the rule, annually review the procedures, and quarterly review all sales for compliance. Similarly, rule 17a-8 permits funds that are affiliated persons solely by virtue of having common or related advisers, common directors, and/or common officers to merge with one another if the funds' boards, including a majority of each board's independent directors, find

[8] Section 17(c) exempts certain sales of merchandise and leases from the section 17(a) prohibition.

[9] If a registered company and a person covered by section 17(a) seek to engage in a series of transactions, the Commission may not exempt them under section 17(b). It may, however, use its authority in section 6(c) (15 U.S.C. § 80a-6(c)) to exempt the series of transactions with reference to the standards set forth In section 17(b). Keystone Custodian Funds, Inc., 21 S.E.C. 295, 299 (1945).

[10] 15 U.S.C. § 80a-6(c).

[11] Section 10(a) generally provides that an investment company may not have a board more than 60% of the members of which are interested persons. "Interested person" is defined in section 2(a)(19) to include persons with certain relationships to the investment company or to the securities industry generally as well as persons with certain relationships with such persons. We use the term "independent directors" to refer to those directors who are not interested persons.

that the transaction is in the best interests of the investment companies and that the interests of shareholders will not be diluted.[12]

3. Section 17(d) and Rule 17d-1

Section 17(d) makes it unlawful for an affiliated person of or principal underwriter for a registered investment company, or any affiliated person of such a person or principal Underwriter, acting as principal, to effect any transaction in which the registered company is a 'oint or a joint and several participant, in contravention of Commission rules." In contrast to section 17(a), section 17(d) does not directly prohibit any specific conduct. Rather, it allows the Commission to adopt rules that set standards for transactions in which investment companies are joint participants.

The Commission has adopted three rules under section 17(d), the most significant of which is rule 17d-1.[14] Rule 17d-1 prohibits an affiliated person of or principal underwriter for any registered investment company, or any affiliated person of such person or underwriter, acting as principal, from participating in or effecting any transaction in connection with a joint enterprise or other joint arrangement in which the investment company is a participant, without prior

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[12]Rule 17a-1 exempts certain purchases by an investment company acting as an underwriter; rule 17a-2 exempts certain commercial transactions; rule 17a-3 exempts transactions with fully owned subsidiaries; rule 17a-4 exempts sales pursuant to certain contracts executed prior to the existence of any affiliation; rule 17a-5 exempts pro rata distributions to stockholders; and rule 17a-6 exempts certain transactions with "downstream" affiliates.

[13]The term "joint" has not been interpreted as requiring a strict common law meaning. Rather, only "some element of 'combination' is required." SEC v. Talley Indus., Inc., 399 F.2d 396,402-03 (2d Cir. 1968), *cert. denied,* 393 U.S. 1015 (1969).

[14]For the first 17 years after the AcYs passage, the Commission prohibited very few joint transactions. The Commission first adopted a rule under section 17(d) in 1946. That rule concerned only bonus, profit-sharing, and pension plans and arrangements "provided by" investment companies "for directors, officers and other affiliated persons." Adoption of Rule Governing Applications Regarding Bonus, Profit-sharing and Pension Plans and Arrangements, Investment Company Act Release No. 858 (Feb. 6, 1946), 11 FR 1461. Thus, as originally promulgated, rule 17d-1 prohibited only a limited class of transactions with first tier affiliates. This version of the rule was later amended in Applications and Exemption of Transactions Between Registered Companies and Fully Owned Subsidiaries, Investment Company Act Release No. 1060 (June 23, 1947), 12 FR 3441, and Applications Regarding Bonus, Profit-sharing and Pension Plans, Investment Company Act Release No. 1598 (Mar. 20, 1951), 16 FR 2680. Rule 17d-1 in substantially its present form, prohibiting a broad range of joint transactions, was adopted in 1957. Applications Regarding Joint Enterprises and Certain Profit-sharing Plans, Investment Company Act Release No. 2472 (Jan. 10, 1957), 22 FR 426.

Commission approval." Thus, the rule effectively prohibits joint transactions or arrangements involving either first tier or second tier affiliates, absent Commission approval.

The rule has limited exceptions for certain employee compensation plans, certain tax-deferred employee benefit plans, certain transactions involving small business investment companies, transactions with "downstream" affiliates (where the affiliation arises solely because of the investment company's portfolio holdings), the receipt of securities or cash by certain affiliates pursuant to a plan of reorganization, and arrangements regarding liability insurance policies.

The Commission has acknowledged that there is considerable uncertainty about the scope of the section and the rule.[16] In 1967, the Commission proposed amending the rule in an attempt to delineate its scope more precisely. In its release, the Commission observed that:

> [u]nder the present Rule, it is in some circumstances unclear whether an application should or should not be filed, and a considerable amount of the staff's time is absorbed in assisting registered companies and their affiliates to determine the applicability of the filing requirement, apart from any determination of approval or disapproval on the merits.[17]

Among other things, the amendment would have reduced the number of affiliates subject to the rule by excluding five percent shareholders of five percent shareholders. It also would have excluded investment companies that are affiliated solely because they had the same adviser and would have attempted to

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[15] *Talley* held that the Commission did not exceed its authority when it adopted rule 17d-1, a procedural rule requiring prior approval, rather than a substantive rule. 399 F.2d at 404-05.

[16] In Steadman Security Corporation, Investment Company Act Release No. 9830 (June 29, 1977), 46 S.E.C. 896,911, the Commission stated that "[t]he generality of [the] language [of section 17(d),] together with the paucity of judicial decisions construing it, has led to considerable uncertainty as to its exact scope."

[17] Notice of Proposal to Adopt a Revision of Rule 17d-1 Requiring Applications For Transactions in Which Investment Companies Participate with Affiliated Persons, Investment Company Act Release No. 5128, [1966-67 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,477, at 82,949 (Oct. 13,1967).

limit the class of transactions subject to the rule. The amendment was withdrawn, apparently in response to the criticism of commenters who believed the proposal would expand rather than clarify the rule.[18]

4. Section 10(f) and Rule 10f-3

Section 10(f) generally prohibits a registered investment company from purchasing securities during the existence of an underwriting syndicate if a member of the syndicate is affiliated with the investment company in certain ways. Section 10(f) prevents an affiliated underwriter from lacing or "dumping" unmarketable securities with an investment company.[19] Section 10(f) also expressly provides the Commission with authority to exempt transactions by rule or by order.

Under its exemptive authority, the Commission has adopted rule 10f-3, which exempts purchases from an underwriting syndicate that includes an affiliate, subject to several conditions relating to the nature of the offering and the terms of an investment company's participation. In particular, the securities must either be registered under the Securities Act[20] or be municipal securities.

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[18]SEC Rule Proposals Withdrawn, Investment Company Act Release No. 5874, [1969-70 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,758 (Nov. 7,1969). For example, the Investment Company Institute ("ICI") argued that the rule would have required applications for many coincidental purchases of securities where there was no joint participation. *See* Letter of Robert L. Augenblick, President, ICI, to the Commission (Jan.17, 1968). Other attempts to reform the regulatory treatment of joint transactions have not been successful. According to the American Law Institute, for example:

> the uncertainty as to the range of transactions covered by [section 17(d)], prompted an attempt at an entirely new approach to the section designed to clarify its coverage and relax its strictness to the extent of interposing the unrelated directors to blunt the intrusion of court or Commission in reviewing a challenged transaction. But disagreement among the Consultants and Advisers with respect to an acceptable (let alone a desirable) solution of the problems -- together with the rejection of proposed changes by spokesmen for the industry -- led to a decision, particularly in the light of the Code's limited approach to substantive revision of the Investment Company Act, to leave [section 17(d)] substantially as it is today.

2 A.L.I. FED. SEC. CODE, § 1412 cmt. 3 (1980).

[19]One of the major abuses noted in the period preceding the Act was the use of investment companies as a "dumping ground' for otherwise unmarketable securities. *See Investment* Trusts *and Investment Companies: Hearings on S. 3580 Before a Subcomm.* of *the Senate Comm. on Banking and Currency,* 76th Cong., 3d Sess. 35 (1940) (statement of Commissioner Healy).

[20]Securities Act of 1933, 15 U.S.C. §§ 77a-77aa.

B. Business Development Companies

In 1980, Congress amended the Investment Company Act to allow for a less regulated type of management investment company, the business development company ("BDC").[21] Congress determined that the regulatory structure applicable to investment companies needed to be modified to facilitate venture capital formation.

The result is that although BDCs are subject to section 10(f) to the same extent as are registered investment companies, the treatment of other affiliated transactions involving BDCs is somewhat different. They are regulated under section 57[22] (rather than section 17) in one of two ways, depending on the closeness of the affiliation between the BDC and the affiliates involved in the transaction.[23] Transactions involving closer affiliates require prior Commission approval, as do transactions under section 17.[24] Transactions involving persons less closely affiliated with a BDC[25] may be approved by majority vote of the BDC's board, including a majority of the BDC's independent directors. The findings the directors must make are essentially the same as those required for Commission orders under section 17(b).

Thus, a BDC may engage in either principal or joint transactions with remote affiliates without seeking Commission approval if the directors of the BDC approve the transaction.[26] The 1980 amendments preserve the need for

[21]Pub. L. No. 96-477, 94 Stat. 2275 (1980) (codified as amended at 15 U.S.C §§ 80a-53 to 80a-64).

[22]15 U.S.C. § 80a-56.

[23]Section 57 also differs from subsections (a) and (d) of section 17 in that it expressly prohibits only *knowingly* borrowing from, or engaging in joint transactions with, BDCs.

[24]Like section 17(d), section 57(a)(4) prohibits only those joint transactions with affiliated persons that are in contravention of Commission rules. Section 57(i), however, provides that, until the Commission adopts rules under subsection (a) and (d), the rules under subsections (a) and (d) of section 17 shall apply. Because the Commission has not adopted rules under section 57(d), rule 17d-1 requires prior Commission approval of those joint transactions involving BDCs that cannot be approved by BDC boards.

[25]These more remote affiliates are those specified in section 57(e). See infra note 45 and accompanying text.

[26]In addition, rule 57b-1 (17 C.F.R. § 270.57b-1) exempts transactions with certain "downstream affiliates" (affiliates that are directly or indirectly controlled by a BDC, and any persons controlling, controlled by, or under common control with, those controlled affiliates). Section 57 (continued...)

Commission approval where an "upstream affiliate," such as an officer, director, investment adviser, principal underwriter, or controlling person of the BDC, is a participant. Thus, those transactions that present a greater risk of self-dealing remain subject to prior Commission review.[27]

Because the provisions of the Act concerning transactions involving BDCs and their affiliates are less restrictive than for other investment companies, the Act imposes additional governance requirements on BDCs to limit possible overreaching. Section 56(a)[28] requires that the majority of a BDC's board consist of persons who are not interested persons of the BDC, rather than the forty percent required of boards of registered investment companies under section 10(a). Section 57(h) requires that the directors adopt and periodically review and update procedures designed to monitor the possible involvement of those persons who are subject to the restrictions of section 57 in transactions with the BDC. Finally, section 57(f)(3) requires BDC directors to record in the minutes of their meetings detailed information about their decisions to approve transactions with affiliates.

III. Options for Reform and Recommendations

As the Commission noted in the release seeking comments on the regulation of investment companies,[29] the prohibitions of section 17(a) and rule 17d-1 and the procedures for approval thereunder have been criticized as unduly

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[26](...continued)
does not cover transactions with some affiliates that are covered by section 17(a). Specifically, section 57(f) does not limit transactions with persons a BDC controls or with which it is affiliated because it holds at least five percent of their outstanding securities, and affiliated persons of those persons. The Commission has adopted an exemptive rule, rule 17a-6, that provides essentially the same relief for investment companies.

[27]*See* SMALL BUSINESS SECURITIES ACTS AMENDMENTS OF 1980, S. REP. NO. 958, 96th Cong., 1st Sess. 7-8 (1980) [hereinafter 1980 SENATE REPORT].

[28]15 U.S.C. § 80a-55(a).

[29]Request for Comments on Reform of the Regulation of Investment Companies, Investment Company Act Release No. 17534 (June 15, 1990), 55 FR 25322, at § III.J.4. [hereinafter Study Release]. Unless otherwise indicated, all references in this chapter to commenters and comment letters are to those responding to the Study Release.

cumbersome; and some commentators have criticized rule 17d-1 as overbroad, unclear, or inconsistent with the purpose of section 17(d).[30]

From the standpoint of cost and efficiency, it is desirable to limit the number of prohibited affiliated transactions requiring Commission approval and to clarify what transactions are prohibited. Moreover, because of the time and cost attendant to filing an application, it is probable that many transactions that do not involve overreaching are simply foregone; thus, the restrictions also may impose opportunity costs on investment companies.

From the standpoint of investor protection, however, the Investment Company Act's provisions concerning affiliated transactions are at its heart and continue to serve as a fundamental protection. The provisions were intended to go beyond those provided under common law, which allows fiduciaries to deal with their beneficiaries if adequate disclosure is made.[31] They are also greater than the protections provided to investors in other domestic pooled investment vehicles, such as common trust funds and real estate investment trusts, and in foreign investment companies.[32]

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[30] *See, e.g.,* Joseph W. Bartlett & Stephen P. Dowd, *Section* 17 of *the Investment Company Act -- An Example* of *Regulation* by *Exemption,* 8 DEL. J. CORP. L. **449 (1983).** In response to the Study Release, several commenters addressed affiliated transactions, including: certain members of a subcommittee of the American Bar Association; the American Council of Life Insurance; Citicorp; Debevoise & Plimpton, on behalf of the independent trustees of the Fidelity Funds; Dechert Price & Rhoads; The Equitable Life Assurance Society of the United States; Fidelity Management & Research Company; R. James Gormley; IDS Financial Services, Inc.; the ICI; Merrill Lynch & Co., Inc.; a committee of the Association of the Bar of the City of New York; Prudential Mutual Fund Management; Ropes & Gray; Shearson Lehman Brothers, Inc.; and Warburg Investment Management International, Ltd.

[31] *See* Thomas P. Lemke, *The Investment Company Act of 1940,* in 4 SECURITIES LAW TECHNIQUES TRANSACTIONS LITIGATION (A.A. Sommer, *ed.)* § 83-07, at 83-135 (Aug. 1991).

[32] For example, under the regulations of the Comptroller of the Currency, a common trust fund may engage in principal transactions with affiliates if authorized by the governing trust instrument, a court order, or the law of the jurisdiction under which the trust is administered. 12 C.F.R. § 9.12. Some affiliated transactions may be approved by a majority of the bank's outside directors or "cured' through disclosure. *Id.* A real estate investment trust, under the statement of policy of the North American Securities Administrators Association, which (as of March, 1991) had been adopted in 20 states, may engage in certain transactions with affiliates if a majority of its trustees (or directors), including a majority of its independent trustees (or directors), approve the transaction. NASAA Reports (CCH) ¶¶ 263, 3404 (1991). The European Community's Directive on Undertakings For Collective Investment in Transferable Securities, discussed in Chapter 4, has no prohibition on transactions with affiliates. European Council Directive of 20th December 1985 on the Coordination of Laws, Regulations and Administrative Provisions Relating to Undertakings for Collective Investment in Transferable Securities, Council Directive 85/611,

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The need for the protections provided by the affiliated transaction provisions of the Investment Company Act has not diminished with the passage of time and is amply demonstrated by a recent enforcement action, SEC *v. Groshans.*[33] In that case, the Commission obtained a permanent injunction against the chairman and president of a mutual fund, and the appointment of a trustee, based primarily on an affiliated transaction. The chairman sold all of the stock of a company in which he owned a ninety-six percent interest to the fund for shares of the fund. He then assigned an artificial value of $1.05 per share to the stock and artificially raised the price of the stock each day thereafter causing the net asset value of the fund to be overstated. He eventually redeemed his fund shares for over $2 million.[34]

Other sectors of the financial services industry demonstrate the consequences of similar kinds of transactions. Some of the most publicized abusive transactions in recent years have occurred in the savings and loan industry. In addition, some sources have estimated that various forms of "insider abuse" have played a significant role in bank failures.[35]

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[32](...continued)
1985 O.J. (L 375) 3. The current trend in the United States, however, may be in favor of tighter controls, particularly with respect to principal transactions. For example, the Commodity Futures Trading Commission has proposed a rule that would prohibit a commodities pool operator ("CPO") from using funds or property of a commodities pool that it operates to lend money or property to or purchase assets of or securities issued by such CPO or any affiliated person of such CPO; "affiliated person of a CPO is defined as any entity in which the CPO has an "interest." Proposed Regulation Prohibiting Certain Transactions Between Commodity Pool Operators and Affiliated Persons, 56 FR 50067 (Oct. 3, 1991), corrected at 56 FR 55527 (Oct. 28, 1991).

[33]Civ. Act. No. 90-6703 (E.D. Pa.) [cited in Litigation Release No. 12677 (Oct. 19, 1990)].

[34]*Id.*

[35]*See* Note, *Insider Abuse and Criminal Misconduct in Financial Institutions: A Crisis?,* 64 NOTRE DAME L. REV. 222, 226-229 (1989) (discussing an Office of the Comptroller of the Currency study of bank failures, a General Accounting Office study of bank and thrift failures, and a Federal Deposit Insurance Corporation study of bank failures); *compare with* LAWRENCE J. WHITE, THE SAVINGS AND LOAN DEBACLE: PUBLIC POLICY LESSONS FOR BANK AND THRIFT REGULATION 126-128 (1991) (attributing the largest set of failures to poor business judgments exacerbated by economic conditions, rather than to abuse). In addition, for an example of abusive transactions involving a savings and loan, see Lincoln Savings and Loan Assoc. v. Wall, 743 F. Supp. 901 (D.D.C. 1990) (describing, among other things, a series of transactions involving a savings and loan and its affiliates that resulted in the looting of the thrift). See *also* Catherine Yang with Dean Foust, *Disaster on a Watchdog's Doorstep,* Bus. WK., June 3, 1991, 114 (describing loans to insiders at Madison National Bank).

Thus, there is a need to maintain investor protection for transactions where abuses are likely to occur while eliminating review by the Commission for transactions that do not pose the same potential for abuse. Accordingly, the Division recommends some additional exclusions under section 17(d) but does not recommend any wholesale changes to the current regulatory system and specifically does not recommend any changes to section 17(a). We propose that rule 17d-1 be amended to permit the following joint transactions: (i) transactions with certain remote affiliates when certain conditions are satisfied, including approval of the directors; and (ii) transactions in which the investment company and any affiliate participate on identical terms except for the amount of their participation. We also propose that rule 10f-3 be amended to permit investment companies to participate in foreign offerings if certain conditions are satisfied that provide protections comparable to those provided by the current requirements.

A. Section 17(a) and Riskless Principal Transactions

The Division does not recommend changes to section 17(a). We considered whether to recommend that the Commission exempt "riskless principal" transactions from section 17(a), and instead treat them like agency transactions under section 17(e). Under section 17(e) brokerage transactions with affiliates are permitted, subject to limits on the amount of compensation an affiliate may receive, depending on the market where the transaction is effected. For transactions effected on an exchange, the commission must not exceed the usual and customary broker's commission.[36] For transactions effected in connection with a secondary distribution, the commission may not exceed two percent of the sales price. For other transactions, such as over-the-counter trades and private placements, the commission may not exceed one percent of the sales price.[37]

[36]Under rule 17e-1, which is a non-exclusive safe harbor for brokerage transactions with affiliates on an exchange, a commission will "be deemed as not exceeding the usual and customary broker's commission" if it is reasonable and fair compared to the fees received by other brokers, the board of the investment company has adopted procedures to monitor compliance with this standard and quarterly reviews compliance, and the investment company maintains records of its procedures and its transactions with affiliates. Disclosure of commissions paid to affiliated brokers is required by Item 17 of Form N-1A, Registration Form Used by Open-End Management Investment Companies; Guidelines, Investment Company Act Release No. 13436 (Aug. 12, 1983), 48 FR 37928 (requiring this disclosure in the Statement of Additional Information) and by Item 9 of Form N-2, 47 FR 39986,40047.

[37]Compliance with section 17(e) does not obviate the affiliate's duty to provide best execution. In proposing rule 17e-1, the Commission noted that "any transaction executed by an affiliated broker must satisfy also the investment company's obligation to obtain best price and execution in each securities transaction." Agency Transactions by Affiliated Persons on a Securities Exchange, Investment Company Act Release No. 10605, n.9 (Feb. 27, 1979), 44 FR 12202. See *also*
(continued...)

We do not recommend adopting a rule exempting riskless principal transactions because of the substantive differences between agency and riskless principal transactions. Even under a rule modeled on the safe harbor for affiliated broker's commissions under rule 17e-1, some conflicts of interest would remain. Moreover, it is difficult to monitor the execution provided by an affiliate in a riskless principal transaction and hence to determine whether the price and transaction costs meet standards comparable to those under section 17(e).

Riskless principal transactions typically are performed by dealers other than market makers in a security. They are unlike most principal transactions in that the dealer does not execute a customer's purchase or sale order from the dealer's existing inventory. Rather, the dealer executes the order by engaging in simultaneous transactions after locating a counterparty in the open market: the dealer purchases or sells the security from the customer for its own account and offsets that transaction with a simultaneous sale to, or purchase from, the counterparty.[38] Instead of a commission, the dealer typically receives a markup on the transaction. Riskless principal transactions are commonplace in some markets, particularly for transactions in debt securities.

Investment companies may not engage in riskless principal transactions with their affiliates, because such transactions involve the purchase or sale of securities by an affiliate acting as principal and are prohibited under section 17(a). Yet, in many respects, riskless principal transactions are functionally equivalent to brokerage transactions and may present less risk of overreaching than do typical principal transactions.[39] Most principal transactions present at least the possibility that the affiliated dealer may be "dumping" a security into an investment company to remove it from its inventory. In a true riskless principal

[37](...continued)
Delaware Management Co., Inc., 43 S.E.C. 392, 400 (1967) ("Persons engaged in the securities business cannot be unaware of their obligation to serve the best interests of customers, and that interpositioning is bound to result in increased prices or costs.") (citation omitted). *Cf.* Edgemont Asset Management Corp. and Bowling Green Securities, Inc., Investment Advisers Act Release No. 1280 (June 18, 1991), 49 SEC Docket 224 (settling administrative proceedings against an investment adviser and a broker regarding interpositioning in trades of fund's portfolio securities).

[38]This definition is drawn from rule lob-10 (17 C.F.R. § 240.10b-10) under the Exchange Act, which requires broker-dealers to provide confirmations. Rule 15c3-1 under the Exchange Act also describes riskless principal transactions. 17 C.F.R. § 240.15c3-1(a)(2)(vi).

[39]Several commenters made this point in response to the Study Release. Letter from Fidelity Management & Research Company to Jonathan G. Katz, Secretary, SEC 8-9 (Oct. 11, 1990), File No. S7-11-90; Letter from the ICI to Jonathan G. Katz, Secretary, SEC 72-73 (Oct. 5, 19901, File No. S7-11-90; Letter from Prudential Mutual Fund Management to Jonathan G. Katz, Secretary, SEC 10-11 (Oct. 9, 1990), File No. S7-11-90.

transaction, the dealer is not selling from inventory, but is acting essentially as an agent.

Riskless principal transactions do differ in some critical respects from agency transactions, however. A key difference is that in a riskless principal transaction the affiliated dealer deals directly with both the purchaser and seller, whereas in most agency transactions the broker does not have relationships with both parties. Thus, it is possible that a transaction might be initiated by an affiliate in order to dump overpriced securities as a favor to another customer.

Most significantly, it appears that monitoring price and execution for many riskless principal transactions is much more difficult than for agency transactions, in large part because of the lesser amount of information about the prices of fixed income securities. In contrast to the equity exchange markets, fixed income markets have few quotes and no trade information available to customers, so it is difficult to assess whether best execution occurred. In the government securities markets, the most reliable sources of information about current market prices are the interdealer brokers' screens, which only are available to primary and aspiring primary dealers. Other recently developed sources of quotes such as GOVPX are a promising beginning in improving the availability of price and quotation information on government securities but generally are not comprehensive:' Similarly, in the municipal securities markets, broker's brokers' quotes, such as those provided by Kenney S&P, are generally only available to bond dealers, and not to institutions. Finally, only some dealer quotes on corporate bonds and very limited price information concerning private mortgage-backed securities are available to investors on Telerate.

In addition, the legally mandated disclosure of markups or markdowns is limited, making it even more difficult to monitor the compensation paid in riskless principal transactions. Rule 10b-10[41] under the Exchange Act does not require disclosure of markups or markdowns by dealers in debt securities, nor does it require such disclosures for market makers in non-reported equity securities; instead, rule 10b-10 requires disclosure of markups or markdowns only

[40]DEPARTMENT OF THE TREASURY, SEC, AND BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, JOINT REPORT ON THE GOVERNMENT SECURITIES MARKET B-87 to E90 (1992).

[41]17 C.F.R. § 240.10b-10.

for transactions by non-market makers in equity securities and transactions by any dealer in non-reported equity securities.[42]

For these reasons, enactment of a rule exempting riskless principal transactions from section 17(a) would not be feasible at present. There currently is not sufficient information available about prices and markups in riskless principal transactions that investment companies and their directors could comply with restrictions comparable to those in section 17(e) and the rule 17e-1 safe harbor for affiliated brokers' commissions.[43] Although a rule exempting all riskless principal transactions would not be appropriate at this time, the Commission might issue individual exemptive orders involving fund trades in high quality, liquid debt securities provided that applicants demonstrated that adequate information and safeguards existed.

B. Section 17(d)

1. Approval by Directors of Joint Transactions with Remote Affiliates

The Division recommends permitting investment companies to engage in some affiliated transactions currently subject to section 17(d) with the approval of their directors, including their independent directors. The directors could approve specific affiliated transactions if they determined that each transaction met the relevant standards that must now be met for exemptive relief from the Commission. The elimination of the requirement of Commission approval would reduce the burden on investment companies and the Commission staff and the resulting expense and delay. Granting to directors the authority to approve some affiliated transactions makes sense if the group of transactions within their authority is sufficiently circumscribed that the risk of abuse is limited and the board can perform a meaningful review of each transaction. We propose

[42]*Id.* In **1978,** the Commission proposed amendments to rule **lob-10** that would have required disclosures of markups or markdowns received by dealers in debt securities, including municipal securities. Securities Confirmations, Securities Exchange Act Release No. **15220** (Oct. **6, 1978), 43** FR **47538.** The Commission withdrew this proposal in **1982.** Securities Confirmations, Securities Exchange Act Release No. **18987** (Aug. **20, 1982), 47** FR **37919.** Those who opposed amending rule **lob-10** argued that disclosure of markups and markdowns was not material, since debt securities are usually priced by yield.

[43]For example, it would not be possible to determine whether a markup was reasonable and fair compared to those charged in other riskless principal transactions or to adopt and administer procedures designed to ensure compliance with such a standard.

amending rule 17d-1 to permit directors to approve joint transactions with certain remote affiliates on a transaction-by-transaction basis.[44]

The restriction of director approval to transactions involving remote affiliates follows the line drawn in section 57(f), which permits directors of BDCs to approve transactions with those affiliates described in section 57(e).[45] This would allow directors to review joint transactions that Congress has determined create "generally less potential for actual overreaching and . . . generally less conflict between these persons and the directors who would be responsible for reviewing the proposed transaction."[46]

Consistent with the treatment of affiliated transactions in section 57(h), this authority should be accompanied by conditions designed to strengthen the independence and the fact gathering capabilities of the independent directors. Such conditions could include requirements that at least a majority of the fund's directors be independent,[47] fund directors adopt and periodically review and update procedures reasonably designed to prevent overreaching in transactions with affiliates, and detailed minutes be kept of meetings in which the independent directors consider transactions with affiliates. The exemption also

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[44]As discussed in the following section, the Division also recommends rulemaking to allow joint transactions where the fund and its affiliated persons do not participate on different terms, subject to periodic board review rather than transaction-by-transaction approval.

[45]The affiliates subject to this more streamlined procedure include: (1) any person who is an affiliated person by virtue of owning between five percent and 25% of the shares of a BDC, or of being between five percent and 25% owned by a BDC; (2) any officer or director of, or general partner in, any person specified in (1); (3) any person who directly or indirectly controls, is controlled by, or is under common control with any person specified in (1); and (4) with certain specified exceptions, any affiliated person of a director, officer, employee, investment adviser, member of an advisory board or promoter of, principal underwriter for, general partner in, or any affiliated person of any person directly or indirectly controlling or under common control with, a BDC.

[46]1980 SENATE REPORT, *supra* note 27, at 30. The Division recognizes that section 57(f) also permits independent directors of BDCs to approve purchases and sales of property to or from such remote affiliates acting as principal, but, as stated above, such relief would be inappropriate for investment companies.

[47]In Chapter 7, the Division recommends amending the Act to require all investment company boards of directors to have a majority of independent directors.

might require that any fund seeking to rely on the exemption have self-nominating independent directors, as is now required for funds that have plans of distribution under rule 12b-1.[48]

The amendment should make clear that directors may engage outside experts to assist them in evaluating such transactions. While the use of independent experts would not be required, it is critical that the directors understand they have the authority to hire such experts as they deem necessary to judge the fairness of transactions and that, in some instances, such hiring may be necessary for the directors to meet their fiduciary obligations. Fund directors do not have the time or, in many cases, the capability to perform independent fact gathering. Thus, in reviewing affiliated transactions, they may be forced to rely on facts presented by the adviser unless they are able to hire personnel to gather facts for them.

The directors would have authority to approve only joint transactions, and not principal transactions under section 17(a), because there are significant differences between joint and principal transactions. All principal transactions squarely present potential conflicts of interest since the affiliate and the investment company are on opposite sides of the transaction. Joint transactions, by contrast, present less risk that securities are being "dumped" on an investment company by an affiliate. Joint transactions also appear better suited to review by the board because they would occur substantially less frequently than would principal transactions and in many cases would be easier to evaluate than principal transactions. Indeed, some commenters recommended that joint transactions under section 17(d) be permitted if approved by the independent directors of the investment company, but did not suggest this approach for principal transactions.[49]

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[48] 17 C.F.R. § 270.12b-1. In Chapter 7, the Division also recommends amending section 10 of the Ad to require that all investment company boards of directors have self-nominating independent directors. Commenters that recommended board approval of joint transactions also suggested that such authority be subject to similar conditions. Letter from Ropes & Gray to Jonathan G. Katz, Secretary, SEC 11 (Oct. 9, 1990), File No. S7-11-90 [hereinafter Ropes & Gray Study Comment] (also suggesting that section 36(b), 15 U.S.C. § 80a-35(b), should apply to any participation in a joint transaction involving an adviser or principal underwriter or any of their affiliates); Letter from Debevoise & Plimpton, on behalf of the independent trustees of the Fidelity Funds, to Jonathan G. Katz, Secretary, SEC 6-7, 9 (Oct. 10, 1990), File No. S7-11-90 (also suggesting that independent directors have direct access to the fund's independent auditors; be represented by independent counsel; have periodic executive sessions; document proceedings in which they are involved; and, where appropriate, rely on information and advice furnished by independent auditors, counsel, or other appropriate consultants).

[49] *See, e.g.*, Ropes & Gray Study Comment, supra note 48, at 11 .

In addition, principal transactions require particular caution because they almost invariably carry the risk of overreaching. For example, if an investment company purchased a debt security from an affiliated market maker and, later, the issuer of the security defaulted, the affiliate could argue that the transaction was fair if it was done at fair market value, as determined by contemporaneous transactions with unrelated third parties. Nevertheless, it always remains open to question whether the investment company would have purchased the security at all if it were not for the affiliation. That is, transactions with affiliates at a "fair market price" may still compromise the unbiased nature of the portfolio management of the investment company.

a. Director Approval of All Affiliated Transactions under Section 17

The Division does not recommend that directors should have the authority to approve *all* affiliated transactions under section 17, including principal transactions and transactions with closer affiliates. Principal transactions in particular raise serious concerns, which we have discussed in the previous section. Moreover, we do not believe that general corporate law standards governing directors' conduct provide investor protection comparable to the current requirement of Commission approval. Some commenters had argued that the Commission should adopt exemptive rules permitting independent directors, at their option, to determine whether a particular transaction under section 17(a) or rule 17d-1 meets the relevant standards for exemption under the Investment Company Act.[50] In their view, since the enactment of the Act, state corporate law has become better developed as to the role of independent directors in policing possible self-dealing and overreaching by insiders.

While state laws dealing with corporate transactions in which a director or other affiliate has an interest have evolved considerably since 1940, the law has evolved in the context of operating companies, which typically have a very different management structure. The management of an operating company rarely is involved in running another business; accordingly, affiliated transactions

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[50] *See, e.g.*, Letter from Dechert Price & Rhoads to Jonathan G. Katz, Secretary, SEC 7, 30-33 (Oct. 10, 1990, revised Oct. 15, 1990), File No. 57-11-90; *see also* Letter from Citicorp to Jonathan G. Katz, Secretary, SEC 25 (Oct. 10, 1990), File No. S7-11-90. This approach was suggested in 1976 by two Commission staff members. Alan Rosenblat & Martin E. Lybecker, *Some Thoughts on the Federal Securities Laws Regulating External Investment Management Arrangements and the ALI Federal Securities Code Project*, 124 U. PA. L. REV. 587, 634-51 (1976) (also suggesting subjecting service contracts (such as transfer agency, custodial, and accounting support contracts) to section 17(a), but exempting such contracts where a majority of the independent directors approve the contracts).

tend to arise on a more limited basis and often only in the context of unusual corporate events, such as contests for corporate control.

By contrast, the management of an investment company usually is performed by another business enterprise that has its own pecuniary interest and also has other significant ongoing business operations that create numerous opportunities for transactions between affiliates and the investment company. For example, many investment companies are affiliated with broker-dealers or with other diversified financial services concerns having a wide range of investments and operations. In those interactions, the interests of the investment company and the affiliate often diverge. Accordingly, state law governing the decisions of corporate directors may not provide sufficiently specific standards for the directors' approval of numerous portfolio and other transactions on an ongoing basis.[51]

Moreover, because of the limitations on the information and time available, directors, and in particular the independent directors, could be overwhelmed if they were required to evaluate and approve a large number or wide range of affiliated transactions, particularly principal transactions. A typical investment company that is affiliated with a large broker-dealer might effect numerous principal transactions with the affiliated dealer, on a daily basis, absent the prohibitions of section 17. Asking fund directors to review numerous transactions is not only unrealistic, but might also interfere with the critical role independent directors play in overseeing the operations of the company by distracting their attention from broader issues. Indeed, the larger the number of transactions that the directors must review, the harder it would be for directors to scrutinize the merits of each transaction.

[51] A related question in delegating such authority is whether section 36(b) should apply to director-approved affiliated transactions. Section 36(b) imposes a fiduciary duty on an investment company's investment adviser with respect to the amount of compensation received from the company by the adviser or an affiliate of the adviser; it currently does not apply to transactions subject to section 17, however. Subjecting director-approved affiliated transactions to section 36(b) would not provide sufficient additional protection to obviate the need for prior Commission review. To police overreaching effectively, the Commission's ability to bring actions under section 36(b) would have to be supplemented by private actions. It is unclear, however, how private parties would ever be able to monitor abusive transactions involving an investment company and its affiliates..

2. Permitting Joint Transactions on an Equal Basis

The Division also recommends amendments to rule 17d-1 to permit certain types of joint transactions by an investment company and its affiliates where the investment company partici ates on terms not different from those applicable to any affiliated participant?' Over the years, the Commission has issued a number of exemptive orders allowing investment companies and BDCs and certain affiliates to invest jointly in securities, if a number of conditions are met to ensure that the company's participation is on a basis not less favorable than any affiliate.[53] Those orders require, among other things, that the investment company and its affiliate purchase the same class of security at the same time and at the same price. They also have conditions concerning the timing of disposition of the security and typically require the independent directors of the investment company to review or approve such purchases.

Similarly, in the 1970s, the Commission proposed an amendment to rule 17d-1 to permit a practice known as "bunching," in which an investment company and its affiliates combine contemporaneous purchases or sales of securities of their various investment portfolios.[54] Commenters generally supported the proposal, but the Commission withdrew it in 1976, citing several concerns.[55] The Commission questioned whether the elimination of fixed commissions had eliminated the economic considerations supporting the exemption. The Commission also indicated that three questions raised by the rule would be better resolved on a case-by-case basis, through the consideration of exemptive applications: (1) whether bunching would be consistent with the fiduciary duties of affiliates; (2) whether affiliates could reap a disproportionate benefit; and (3) how to combine non-concurrent orders such as limit orders or partially executed orders. We have reevaluated those concerns and believe they can be

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[52] *Cf.* Letter from R. James Gormley to Jonathan G. Katz, Secretary, SEC, attached memorandum at 14 (Oct. 24, 1990), File No. S7-11-90.

[53] One commenter suggested codifying these orders. Letter from The Equitable Life Assurance Society of the United States to Jonathan G. Katz, Secretary, SEC 25-27 (Oct. 5, 1990), File No. S7-11-90.

[54] Joint Enterprises or Arrangements and Certain Profit-sharing Plans, Investment Company Act Release No. 7035 (March 9, 1972), 37 FR 5831.

[55] Bunching Rule, Withdrawal of Proposal, Investment Company Act Release No. 9170 (Feb. 19, 1976), 41 FR 8799.

addressed in an exemptive rule, rather than by requiring individual applications for such transactions.[56]

In addition, some transactions exempted during the last few years share some of the characteristics of the bunching proposal and exemptive orders discussed above. The Division believes those transactions would similarly be amenable to regulation under an exemptive rule. For example, the Commission has exempted joint repurchase agreements, where two or more investment companies in the same complex jointly invest their excess cash in one or more repurchase agreements, resulting in cost savings and higher interest earned for each of the participating funds.[57] The Commission also has exempted the affiliates of several investment companies from rule 17d-1 to permit them to join in a lawsuit against the issuer of securities each of them held and share all legal fees and expenses in proportion to their respective securities holdings.[58]

These transactions do not present the risks that section 17(d) was designed to prevent: the participation by an investment company "on a basis different from or less advantageous than that of [any] other participant."[59] Rather, in each case, the investment company and its affiliates participate on the same terms, except as to the amount of their participation. Accordingly, the Division recommends an amendment to rule 17d-1 to permit any joint transaction where

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[56]One commenter suggested an amendment to rule 17d-1 to permit bunching of trades with affiliates, subject to five conditions: (1) the transaction involves only a cash payment against prompt delivery of a security; (2) the net price for the securities purchased or sold is the same to each participant; (3) the allocation of actual trades is substantially in proportion to the participants' orders; (4) the transaction is consistent with the investment company's policy; and (5) the investment company's board, including its independent directors, determines that transactions will be of benefit to the investment company. Letter from the American Council of Life Insurance to Jonathan G. Katz, Secretary, SEC 123-24 (Oct. 10, 1990), File No. S7-11-90. Similarly, another commenter recommended that the rule be amended to exempt "concurrent purchases or sales of portfolio securities by funds in the same complex." Letter from the Subcommittee on Investment Companies and Investment Advisers of the Committee on Federal Regulation of Securities, Section of Business Law, American Bar Association, to Jonathan G. Katz, Secretary, SEC 29 (Oct. 18, 1990), File No. 57-11-90 [hereinafter ABA Study Comment].

[57]*See, e.g.*, ABT Growth and Income Trust, Investment Company Act Release Nos. 17626 (July 30, 1990), 55 FR 31933 (Notice of Application) and 17712 (Aug. 29, 1990), 46 SEC Docket 1990 (Order).

[58]*See* The Prudential Insurance Co. of America, Investment Company Act Release Nos. 17568 (July 3, 1990), 55 FR 28499 (Notice of Application) and 17644 (Aug. 2, 1990), 46 SEC Docket 1609 (Order).

[59]Rule 17d-1(b) (describing standard for Commission consideration of applications seeking approval of joint transactions).

an investment company and its affiliates participate on equal terms, except for the amount of the participation. The exemption would require the board of the company, including a majority of the independent directors, to establish procedures to ensure that the transactions are within the exemption, and to determine periodically that the participation of the fund in the joint transactions continues to be in its best interest.

The Division believes that the amendment also should make clear that an exemption from section 17(d) and rule 17d-1 does not by itself address all questions under the Investment Company Act, other federal securities laws, or state laws. For example, it would not address whether an adviser to an investment company, as a fiduciary, is obligated to put the fund's trade ahead of its own or those of other clients.[60] Such concerns are not within the gambit of section 17(d), which allows the Commission to adopt rules to prevent participation by an investment company on a basis different from or less advantageous than that of other participants. Thus, if a transaction is on equal terms among the company and its affiliates, it is inconsistent with the purposes of the section to prohibit the transaction absent a Commission order, whether or not some other provision of law may prohibit joint participation. Therefore, the amendment would clarify, for example, that practices such as "bunching" are not prohibited under rule 17d-1, but may be subject to limitations under other legal standards.

3. Narrowing the Scope of Section 17(d) and Rule 17d-1

The Division also considered three other ways to reduce the scope and attendant costs of the prohibition on joint transactions. One way would be to limit the prohibition to transactions where a fund and its affiliate are on the same side of the transaction, thereby excluding from the rule more complex arrangements. A second would be to reduce the number of affiliates subject to the prohibition. A third would be to replace rule 17d-1's application requirement with a rule that simply prohibits overreaching. As discussed below, we conclude that none of these proposals would provide adequate investor protection.

[60]That question is not addressed by rule 17d-1 today. We note that section 17(j) and rule 17j-1 require funds and their advisers and principal underwriters to adopt codes of ethics governing securities trading by personnel with access to information about fund trading activities. Some codes of ethics require that such "access persons" effect all their trades in securities after fund trades. *See, e.g.,* Mary Ann Tynan, *Drafting Guide for Codes of Ethics under Rule 17j-1*, ICI MUTUAL FUND TRAINING CONFERENCE, at IV-22 to IV-23 (1987).

a. Prohibiting Only Participation on the Same Side of Transactions

One way to clarify the scope of rule 17d-1 would be to limit its coverage to transactions where the investment company and an affiliate are on the same side. Two commenters recommended clarifying section 17(d) and rule 17d-1 in this manner.[61] One quoted a Commission brief that stated that section 17(d) applies to "a transaction in which the investment company and its affiliated person participate on the same side."[62] The other recommended amending rule 17d-1 to define a joint transaction as a transaction in which an affiliate "knowingly acts in combination with such registered investment company or a controlled company thereof in a manner that results in a potential sharing of the assets, liabilities, profits or losses of such enterprise or undertaking."[63] The commenter argued that "where parties are on opposite sides of the transaction it appears to 'negate the existence or possibility of "some element of combination" that the Second Circuit, in [*Talley*], said "is required" for purposes of Section 17(d) and rule 17d-1.'"[64]

Such a restricted definition of joint transactions would unduly narrow rule 17d-1. While it is true that section 17(d) often is described as applying to transactions where an investment company and its affiliate are "on the same side of the table transacting business with a third party,"[65] courts, the Commission, and the Commission's staff consistently have interpreted rule 17d-1 to apply where the affiliate and the fund are not on the same side of the table, but nevertheless have a joint interest in the transaction.[66] For example, in *Steadman*

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[61]ABA Study Comment, *supra* note 56, at 29; letter from Merrill Lynch & Co., Inc. to Jonathan G. Katz, Secretary, SEC 11-33 (Oct. 18, 1990), File No. S7-11-90 [hereinafter Merrill Lynch Study Comment].

[62]ABA Study Comment, *supra* note 56, at 29, quoting the Commission's brief in *SEC v. Talley Industries, Inc.*, *supra* note 13.

[63]Merrill Lynch Study Comment, *supra* note 61, at 11-32, -33, -38.

[64]*Id.* at 11-33, quoting Morgan Capital Corp. (pub. avail. Oct. 17, 1986). The commenter also suggested that inserting a "knowingly" requirement in the rule would help to clarify that actions such as simultaneous but independent investments are not prohibited. Id. We agree that this would not be a change from current law. (As noted earlier, section 57(a)(4) of the Act, concerning joint transactions by BDCs, has an express "knowingly" requirement.)

[65]*See, e.g.*, LEMKE, *supra* note 31, at 83-136.

[66]*See* SEC v. Commonwealth Sec. Investors, Inc., [1970-71 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,859 (E.D. Ky. Oct. 21, 1970) (enjoining investment company insiders from future (continued...)

Security Corp.,[67] the Commission, in determining that the controlling person of an adviser did not violate rule 17d-1 by having the fund maintain deposits at banks where he obtained personal loans, rejected the argument that section 17(d) applied only to joint ventures and observed that "three party transactions, such as those present here, would seem within section 17(d)'s scope were there a causal connection between the funds' deposits and [the controlling person's] loans."

The reasons for the Commission's position are obvious. As one writer put it:

> Section 17(d) . . . was designed to deal with transactions of the investment company . . . in which affiliates have a conflict of interest. Congress was concerned with overreaching and unfair advantages to insiders. Conflict of interest and overreaching may exist whether or not the affiliates' participation is of the same economic nature. . . . [T]here are many examples in the Act's legislative history of investment companies that were induced to participate not only on different terms but in different economic arrangements. Investment companies' assets were used to finance companies and acquire control of enterprises in which affiliates had personal interests. Investment companies were operated as discretionary brokerage accounts to produce commissions for affiliates. They were used to manufacture securities for promoters in the securities distribution business.[68]

The concerns of the 1940 Congress about overreaching and unfair advantage to insiders are equally relevant today. Indeed, those joint transactions reviewed by the Commission in which the fund and an affiliate do not participate on the same side of the table often involve complex business arrangements. Our experience in reviewing such arrangements suggests that close examination continues to be necessary, especially for those transactions where an investment company and an affiliate will experience different economic consequences.

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[66](...continued)
violations of rule 17d-1 based on their obtaining loans, securities, and fees from a company with which the investment company was negotiating a merger); South Bay Corp. (pub. avail. Dec. 4, 1974) (declining to provide no-action assurance regarding settlement of lawsuit by registered investment company against officers and directors of 45% shareholder of investment company).

[67]*Supra* note 16.

[68]2 TAMAR FRANKEL, THE REGULATION OF MONEY MANAGERS, ch. XIII, § 24.3, at 531-32 (1980 & Supp. 1991) (citations omitted).

b. Narrowing the Group of Affiliates Subject to the Rule

Another way to reduce the uncertainty about the scope of rule 17d-1 would be to reduce the number of affiliates brought within its prohibitions. One commenter recommended amending rule 17d-1 to apply only to transactions where the affiliate is an investment adviser, principal underwriter, or controlling person with respect to the company.[69] Thus, joint transactions with relatively close affiliates such as controlling persons of fund advisers and principal underwriters and with fund officers and directors would be lawful, without any restriction even though such affiliates may still be in a position to exercise significant influence over an investment company. By contrast, in enacting section 57, which permits independent directors of BDCs to approve transactions with remote affiliates, Congress did not accept that such relatively close affiliates presented a reduced risk of overreaching or conflict of interest.

Transactions with many of these relatively close affiliates are as susceptible to overreaching and abuse as are transactions directly with fund advisers and underwriters. Indeed, some of the leading precedents under section 17(d) involve the affiliates that would be excluded under this proposal. For example, in *SEC v. Midwest Technical Development Corporation*,[70] a mutual fund made heavy investments in certain portfolio companies sorely in need of financing. The court found that the investments had been induced by the fund's directors, who had assisted in the organization of the companies. After the strengthening of the financial structure of the portfolio companies by the fund's investments, the directors made their own investments.

In light of those risks, we do not recommend so great a narrowing of the scope of rule 17d-1. We recommend instead, as discussed above, amending rule 17d-1 to make it parallel to the requirements of section 57. Thus, fund directors would have the authority to approve only joint transactions with those more remote affiliates that Congress has determined present little risk of abuse.

c. Prohibiting Only Overreaching

The Division also considered whether to alter the regulation of joint transactions radically by amending rule 17d-1 to prohibit only those joint transactions that involve overreaching. This idea was proposed in 1971 by two

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[69] Letter from the Committee on Securities Regulation of the Association of the Bar of the City of New York to Jonathan G. Katz, Secretary, SEC 2-3 (Oct. 4, 1990), File No. S7-11-90.

[70] [1961-64 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 91,252 (D. Minn. July 5, 1963).

trade associations representing insurers.[71] They suggested that, instead of requiring prior Commission approval, the Commission rely on enforcement actions under an amended rule 17d-1 and section 36(a). The Commission did not pursue this suggestion then, and we do not recommend that it do so now.

Relying on after-the-fact enforcement action to address overreaching would give investment companies and their affiliates the opportunity to do improper transactions subject only to the risk of subsequent and probably incomplete enforcement. It is doubtful that any enforcement could provide a full remedy, because it would be difficult and time-consuming to undo improper affiliated transactions. Even if a transaction could be undone and a fund could be compensated, such actions would not compensate shareholders harmed by the improper transaction who may have redeemed in the interim. For such a rule to be effective, the Division would have to monitor carefully all joint transactions through its examination process -- an impossibility and an extremely intrusive prospect.

C. Section 10(f) and Rule 10f-3

The Division also recommends that rule 10f-3 be expanded to permit investment company purchases of foreign securities that are not currently exempt under the rule from the section 10(f) prohibition on purchases from syndicates containing affiliates.[72] Funds that invest overseas generally are unable to rely on rule 10f-3 because it requires that the securities being purchased either be registered under the Securities Act or be municipal securities. Obviously, in most cases, neither alternative can be satisfied in an overseas offering. The Commission has met that problem by exempting investment companies where the

[71]Memorandum of American Life Convention and Life Insurance Association to the Division of Corporate Regulation, SEC (Feb. 11,1971). One author also discussed this approach in 1972:

> Under [section] 17(d) we might consider a self-operating lob-5 type rule, making overreaching in joint transactions unlawful, rather than the cumbersome application procedure. A blanket exemptive rule could be adopted covering situations where there is an absence of overreaching. This would replace the existing application procedure with a self-operating approach such as that reflected by rule lob-5 under the [Exchange] Act.

Milton P. Kroll, *The 'Portfolio Affiliate' Problem, in* THIRD ANNUAL INST. ON SEC. REGULATION, 261, 290-91 (PLI Sec. Reg. Transcript Series No. 3,1972).

[72]Comments on rule 10f-3 mostly focused on the inability of funds that invest overseas to rely on the rule. *See, e.g.*, Letter of Davis Polk & Wardwell to Jonathan G. Katz, Secretary, SEC 33-34 (Oct. 10, 1990), File No. 57-11-90; Letter of S.G. Warburg & Co. Inc. to Jonathan G. Katz, Secretary, SEC 6-8 (Oct. 12, 1990), File No. S7-11-90.

company represented that the securities regulation of the country in which the company was to purchase securities was "substantially equivalent for purposes of rule 10f-3."[73] This substantial equivalence standard, however, is not attainable in emerging markets that are subject to less regulation than the home market.

Since neither the registration requirement of rule 10f-3 nor the "substantial equivalence" standard of exemptive orders provides relief in markets that cannot meet those requirements, we recommend that rule 10f-3 be amended specifically to permit investment companies to purchase foreign securities in compliance with restrictions that would provide protections comparable to those provided by the current requirements.[74] These might include requirements that the offering be a public offering[75] conducted in accordance with applicable law and that the offering be conducted by means of a firm commitment underwriting.[76] The conditions would also require that audited financial statements of the issuer for the most recent three years be available to prospective purchasers, to ensure that adequate public information is available to the investment company and its adviser and directors to facilitate their review of the investment merit of such securities. These requirements would retain safeguards against "dumping," while removing an unnecessary barrier to portfolio transactions in foreign securities.

IV. Conclusion

The Act's restrictions on transactions with affiliates are among its core provisions. Recent experience has reaffirmed the wisdom of the Act's drafters in imposing those restrictions. Accordingly, we recommend only limited changes in this area. We recommend that the Commission begin rulemaking proceedings to amend rule 17d-1 to permit the directors, including the independent directors, to review and approve all joint transactions with remote affiliates and also to

[73] *See, e.g.,* The Japan Fund, Inc., Investment Company Act Release Nos. 9789 (June 6, 1977), 42 FR 29351 (Notice of Application) and 9832 (June 24, 1977), 12 SEC Docket 1087 (Order).

[74] It appears that the Commission imposed the registration requirement in rule 10f-3 to ensure that the investment company purchased marketable securities, at the public offering price, which ordinarily would not exist absent registration. Registration also tends to ensure that the securities offering is in the ordinary course of business.

[75] We understand, however, that in certain foreign markets public offerings are not conducted at a uniform offering price. A public offering requirement would need to address the issues raised by non-uniform pricing, and especially by the existence of distinct prices for affiliates.

[76] We note that in Japan initial public offerings are bifurcated into two portions, only one of which is on a firm commitment basis. The other portion includes an auction procedure.

permit all joint transactions where the investment company and its affiliates participate on the same terms, except for the amount of the participation; and amend rule 10f-3 to provide relief for purchases overseas similar to that extended to purchases in domestic markets.