



Securities Industry Association

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July 17, 2002

Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

Re: Proposed Amendments to Rules Regarding Transactions of
Investment Companies with Portfolio and Subadvisory Affiliates
(Release No. IC-25557; File No. S7-13-02)

Dear Mr. Katz:

The Investment Company and Investment Adviser Committees of the Securities Industry Association ("SIA")¹ are pleased to submit this letter regarding a proposed new rule and proposed amendments to rules under the Investment Company Act of 1940 ("Investment Company Act" or "Act") that would permit transactions between funds and affiliated entities under circumstances where it is unlikely that the affiliate would be in a position to take advantage of the fund. These proposals represent an appropriate regulatory response to developments within the securities industry, including the widespread growth of subadvisory relationships.

SIA appreciates that the Commission recognizes the benefits to funds and their shareholders of permitting transactions, including principal transactions, between funds and affiliated entities, in circumstances where there is little likelihood of, or opportunity for, abuse. Therefore, we strongly support the Commission's proposals with respect to modification of rules under Sections 17(a), 17(d) and 17(e) of the Investment Company Act. The Committees also support the proposed amendment to rule 12d3-1 under the Act. However, as set forth below, we respectfully request that the Commission consider additional amendments to that rule that would benefit funds and their shareholders.

¹ The Securities Industry Association brings together the shared interests of more than 600 securities firms to accomplish common goals. SIA member-firms (including investment banks, broker-dealers, and mutual fund companies) are active in all U.S. and foreign markets and in all phases of corporate and public finance. The U.S. securities industry manages the accounts of nearly 93 million investors directly and indirectly through corporate, thrift, and pension plans. In the year 2001, the industry generated \$198 billion in U.S. revenue and \$358 billion in global revenues. Securities firms employ approximately 750,000 individuals in the United States. (More information about SIA is available on its home page: <http://www.sia.com>).

Although we strongly support the Commission's proposals for rules under Sections 17 and 12 of the Act, we remain concerned with the possibility that the Commission would amend rule 10f-3 to require the aggregation of purchases by funds that are advised, and accounts that are controlled, by an investment adviser that is a principal underwriter (or affiliate thereof), that is a participant in the underwriting or selling syndicate.²

DISCUSSION

Principal and Other Transactions With Affiliated Entities

We believe that principal and other transactions with affiliates can be highly beneficial to funds and other investors, particularly where circumstances, such as lack of investment control over affiliated entities and increased price transparency and liquidity, substantially reduce or eliminate the likelihood or opportunity for abuse. The proposals reflect the fact that the trading environment has changed over time and, as a result, fair dealing among all parties can be demonstrated with greater clarity. We encourage the Commission to consider further reasonable measures that will enable funds and other investors to fully reap the benefits of high quality, economically beneficial trade executions, *provided* that the core investor protection objectives of Sections 17(a) of the Investment Company Act and 206(3) of the Investment Advisers Act are maintained.

In this regard, we note that former Chairman Levitt commented in April 1999 on the desirability of considering modifications to the principal trading restrictions of Section 206(3):

Given the changing structure of our markets and the corollary effects it is having on our business, I believe this is the right time to consider whether it might be appropriate to provide an exemption from the restrictions on principal trading. While we want to open new opportunities to firms and their customers, there are real risks to allowing principal trading in certain situations – such as in illiquid securities or large, market-moving orders where it is very difficult to know whether the client paid a fair price. While we want to make it easier for firms to get paid for their advice as well as their executions, we will not simply exchange one potential conflict of interest for another.

*The Division of Investment Management will develop amendments to the rule that strike a balance between these two concerns. I believe we can do this without sacrificing the interests of the profession or investors...(emphasis supplied)*³

² The proposal originally appeared in SEC Release IC-24775, November 29, 2000, which addressed principally a proposed exemption of government securities offerings from the proscriptions of Section 10(f) of the Investment Company Act.

³ Speech by SEC Chairman: "Remarks Before the Securities Industry Association's Legal and Compliance Seminar" (April 13, 1999).

More recently, Division of Investment Management Director Paul Roye indicated that transactions in high quality, liquid equity and fixed income securities, principal transactions with sophisticated investors, and riskless principal transactions are among the types of transactions being considered for relief from the principal trading restrictions under Section 206(3).⁴ The staff's latest regulatory agenda projects that a rule proposal would be issued with respect to Section 206(3) this month and we are hopeful that projection will be met.

Proposed Amendment to Rule 12d3-1

SIA appreciates and supports the Commission's proposal to codify prior exemptive relief under Section 12(d)(3) of the Investment Company Act relating to acquisition of securities issued by securities-related businesses. A revised rule 12d3-1 that would permit a fund to acquire securities issued by one of its subadvisers (or an affiliated person of one of its subadvisers) *if* the subadviser (i) provides investment advice to a discrete portion of the fund's portfolio and (ii) is not an affiliated person of the adviser causing the fund to purchase the securities, will certainly benefit funds and their shareholders. This proposal is consistent with those discussed above in that it responds to organizational changes in the fund industry without diminishing important investor protections that are fundamental pillars of the Investment Company Act.

However, as a further refinement to the proposed rule amendment, we respectfully request that the limitation on investment of up to five percent of a fund's assets be increased to 10 percent.

The five percent of fund assets limitation is intended, along with the other percentage limitations contained in rule 12d3-1(b)(1) and (2), to "minimize the potential for conflicts of interest and reciprocal practices by preventing an investment company from acquiring a significant stake in any particular broker or dealer."⁵ While the asset limit is designed to address the potential abuses that the Commission had in mind in adopting rule 12d3-1, there does not seem to be a particular reason that the limit should be set at five percent of fund assets.⁶ When it adopted Rule 12d3-1, the Commission stated: "In view of the broad prohibition in the (Investment Company) Act against

⁴ Paul F. Roye, "Priorities in Investment Adviser Regulation," Remarks Before the IA Compliance Summit and Best Practices Update (April 8, 2002). Another example of the Commission's evolving view of principal transactions is a December 2001 modification of the Section 28(e) safe harbor to include "certain riskless principal transactions." See SEC Release No. 34-45194 (December 27, 2001).

⁵ Investment Company Act Release No. 19204, at 9-10 (January 4, 1993). Rule 12d3-1(b)(1) limits a fund's investments in a single issuer to not more than five percent of the outstanding securities of that class of the issuer's equity securities. Rule 12d3-1(b)(2) imposes a similar limit on acquisition of an issuer's debt securities; namely, that a fund's investments cannot exceed 10 percent of the outstanding principal amount of the issuer's debt securities.

⁶ Indeed, former rule 12d-1, intended to address the same potential abuses, contained no limit based on a percentage of fund assets. Release 19204, at n.8. See also Investment Company Act Release No. 4044 (September 4, 1964) (adopting rule 12d-1).

investment company acquisitions of interests in issuers engaged in securities-related activities, the Commission believes that any exemptive relief must be conditioned upon certain quantitative limitations. The proposed amendments impose reasonable limits on such acquisitions and are therefore adopted.”⁷ For the reasons discussed below, we respectfully suggest that the five percent asset limit is no longer “reasonable.”

In an era of increasing consolidation in the financial services sector, certain securities-related issuers represent more than five percent of the capitalization of the sector and some issuers represent a larger percentage of the broader market than they did in the past.”⁸ Index-type funds that wish to invest in accordance with relative sector weightings must invest more than five percent of their assets in the securities of certain financial services companies.⁹ Similarly, actively managed funds with an investment policy or strategy of investing primarily in the securities of large-capitalization issuers would find it desirable and in accordance with their investment objectives, policies and strategies to invest more than five percent of the fund’s assets in these securities-related issuers. Thus, we believe the five percent asset limit has unintended consequences that may work to inhibit returns.

A ten percent asset limit would enhance the ability of funds such as those described above to achieve their investment objectives while still providing protection against the abusive reciprocal practices that the rule was designed to address. This is because we suggest that the Commission retain the most significant safeguards provided by the rule – the investment limits contained in Rule 12d3-1(b)(1) and (2). These provisions focus the rule squarely on potential reciprocal practices by directly limiting the amount of capital a fund can contribute (directly or through the secondary markets) to a particular securities-related business.

For the foregoing reasons, SIA recommends that Rule 12d3-1(b)(3) be amended to increase the asset limit from five to ten percent.

⁷ Investment Company Act Release No. 14036, at 10-11 (July 13, 1984). The release proposing rule 12d3-1 indicated that the five percent asset limit was “modeled after a condition contained in recent exemptive orders” under Section 12(d)(3) and Rule 12d3-1. Release 13724, at 18. Among other conditions, those exemptive orders limited fund investments in any class of securities issued by certain securities related issuers to ten percent of the fund’s total assets or, if lower, the maximum amount permitted by the fund’s investment policies and restrictions. See American Express Company, Investment Company Act Release Nos. 12987 (January 21, 1983) (notice) and 13061 (March 2, 1983) (order); Kemper Corp., Investment Company Act Release Nos. 13249 (May 17, 1983) (notice) and 13319 (June 14, 1983) (order).

⁸ See, e.g., Financial Select Sector SPDR Fund, Diamonds Trust (pub. avail. July 6, 2000).

⁹ The Commission has, through a no-action letter and a number of exemptive orders, permitted increases in the five percent asset limit for certain investment companies, the portfolios of which represent a stock index or a mechanically selected subset of the stocks in an index. See, e.g., Financial Select Sector SPDR Fund, Diamonds Trust, (pub. avail. July 6, 2000); Investec Ernst & Company, *et al.*, Investment Company Act Release Nos. 25115 (August 17, 2001) (notice) and 25155 (September 12, 2001) (order); Legg Mason Wood Walker, Inc., *et al.*, Investment Company Act Release Nos. 25101 (August 3, 2001) (notice) and 25148 (September 4, 2001) (order).

Rule 10f-3 Aggregation Proposal

As indicated above, SIA objects to the portion of the proposal to amend rule 10f-3 that would require aggregation of affiliated underwriting purchases by funds that are advised, and accounts that are controlled, by the same investment adviser for purposes of the 25 percent limitation in the rule. As the Commission notes, the instant proposal reflects the re-proposing of an amendment originally contained in an earlier SEC release to exempt government securities offerings from the proscriptions of rule 10f-3.¹⁰ SIA filed a comment letter opposing the instant proposal and recommending an alternative calculation formula.¹¹ We are taking this opportunity to reiterate, and elaborate upon, the comments made in our earlier letter.

At the outset, we note that in the instant release the Commission states that while several commentators opposed the proposed amendment on the grounds that it could limit funds' access to primary offerings,¹² none addressed the policy concerns behind the proposal which relate to the potential "dumping of securities" facilitated by the lack of a significant market independent of accounts controlled by the adviser. In our earlier comment letter, we specifically stated that we were not aware of any particular instances of abuse, or other problems that have arisen, under the existing percentage limitation. Furthermore, we specifically recommended that if a more restrictive aggregation requirement were adopted that the percentage be set at or near 50 percent. This would still allow for a substantial market for the underwritten securities independent of accounts controlled by the fund adviser, and coupled with the other protections already incorporated in the rule (e.g., 3-year existence for registered offerings; timing and price requirements) would more than adequately address the Commission's policy concerns, without engendering the negative consequences for fund and non-fund accounts discussed below.

By expanding the reach of rule 10f-3, clients of fund-affiliated advisers (both funds and managed accounts) could be deprived of the opportunity to invest in attractive opportunities, and could, as a result, pay higher prices and costs as a result of having to purchase in the aftermarket, after the syndicate has closed. It is noteworthy that while rule 10f-3 is an Investment Company Act rule, the proposed amendment could potentially adversely affect an investment adviser's non-fund managed accounts, as well as fund accounts. Non-fund clients would now be aggregated with a group of fund investors that, in the aggregate, could not exceed 25 percent of the offering. Furthermore, the amendment could reduce the availability of attractive investment opportunities for investment company portfolios as well, since a portion of the 25 percent allocation might go to the managed accounts.

¹⁰ SEC Release No. IC-24775 (November 29, 2000).

¹¹ Letter to Jonathan G. Katz, SEC Secretary from Gerald T. Lins. Chair, SIA Investment Company Committee regarding "Proposed Amendment to Rule 10f-3 under the Investment Company Act with Respect to Government Securities Offerings" (February 15, 2001).

¹² See footnote 70 of Release No. IC-25557.

It is important to note that there has been significant consolidation in the financial services industry since the adoption of rule 10f-3, and, as a result, it is more likely that a fund-affiliated underwriter will be a member of the underwriting syndicate. Thus, with the adoption of the proposed amendments, clients of underwriter-affiliated advisers would be deprived of more investment opportunities without a showing of any evidence of abuse.

Accordingly, SIA recommends that rule 10f-3 not be amended as suggested by the Commission. Alternatively, in the event that the Commission adopts the amendment, SIA believes that the aggregate percentage limit of an offering should be raised to at or near 50 percent so as to mitigate the negative effects of the proposed amendment.

CONCLUSION

SIA strongly supports the Commission's proposal to amend various Investment Company Act rule restrictions on principal and other affiliate transactions where no significant conflicts of interest exist, or there is otherwise little likelihood or opportunity for self-dealing. We urge the Commission to take similar measures with respect to Section 206(3) of the Investment Advisers Act, and also to adopt our recommendation to increase the percentage limitation under rule 12d3-1(b)(3) to ten percent.

With respect to the proposal to amend rule 10f-3 to require aggregation for percentage limitations purposes among commonly advised or controlled fund and non-fund accounts, we urge the Commission not to adopt the proposal, or alternatively raise the percentage limitation, given the negative impact on underwriting availability and the lack of a history of abuse.

We thank you for the opportunity to comment. Should you have any questions, please do not hesitate to contact Michael D. Udoff of SIA staff at (212) 618-0509.

Sincerely,

Gerald T. Lins
Chair, SIA Investment Company Committee

Paul S. Gottlieb
Chair, SIA Investment Adviser Committee

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