

(Secs. 1-19, 48 Stat. 31, as amended; 7 U.S.C. 601-674).

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SECURITIES AND EXCHANGE COMMISSION

17 CFR Parts 239, 270, 274

[Release Nos. 33-6254, IC-11414, File No. S7-743]

Bearing of Distribution Expenses by Mutual Funds

AGENCY: Securities and Exchange
Commission.

ACTION: Final rules.

SUMMARY: The Commission is adopting a rule to permit open-end management investment companies to bear expenses associated with the distribution of their shares, if such companies comply with certain conditions and procedures. The rule requires that any decision by an open-end management investment company to use its assets to finance distribution be approved by its shareholders and directors, including its disinterested directors. The rule also contains provisions intended to ensure that the disinterested directors are not dominated nor unduly influenced by management and that the directors are fully informed and exercise reasonable business judgment. The procedures in the rule by which shareholders and directors would approve a plan to use assets for distribution are generally similar to those prescribed by statute for approval of investment advisory contracts. The procedural requirements are somewhat less stringent than they were in the rule as proposed.

The Commission also is adopting a rule to exempt from the requirement of prior Commission approval, to the extent necessary, certain agreements between open-end management investment companies and their affiliated persons whereby investment company assets are used for distribution, if such agreements are entered into in compliance with the rule permitting such companies to bear their distribution expenses.

The Commission is adopting certain disclosure and reporting requirements relating to the use of assets for distribution, including a revision of the registration and reporting form for open-end management investment companies.

The Commission is taking these actions because it believes that directors and shareholders of open-end management investment companies should be able to make business judgments to use fund assets for distribution in appropriate cases but that, in view of the investment adviser's conflict of interest with respect to any recommendation to bear distribution expenses and because of uncertainties about whether such companies are likely to benefit from such expenditures, any such exercise of business judgment should be subject to conditions designed to ensure that it is made by persons who are free of undue management influence and have carefully considered all relevant factors.

EFFECTIVE DATE: October 28, 1980.

FOR FURTHER INFORMATION CONTACT: Richard W. Grant, Special Counsel to the Director, (202) 272-2041, Division of Investment Management, Securities and Exchange Commission, 500 North Capitol Street, Washington, D.C. 20549.

SUPPLEMENTARY INFORMATION: The Commission today is adopting rule 12b-1 (17 CFR 270.12b-1) under the Investment Company Act of 1940 (15 U.S.C. 80a-1 et seq.) ("Act") to permit open-end management investment companies ("mutual funds" or "funds") to bear expenses associated with the distribution of their shares. Among the significant provisions of the rule are the following:

—Selection and nomination of directors who are not interested persons of the fund must be committed to the discretion of such disinterested directors;

—A fund which decides to bear distribution expenses must formulate a written plan describing all material aspects of the proposed financing of distribution, and all agreements relating to implementation of the plan must be in writing; such plan and agreements must contain certain provisions similar to those required by the Act for investment advisory contracts;

—The plan must be approved initially: (1) By a vote of at least a majority of the fund's outstanding voting securities; (2) by its board of directors as a whole; and (3) separately by its directors who are not interested persons of the fund and have no direct or indirect financial interest in the operation of the plan or any agreement related to the plan;

—In considering a plan to finance distribution, the directors must give appropriate weight to all pertinent factors; and

—The directors must decide, in the exercise of their reasonable business judgment and in light of their fiduciary

duties under state law and under the Act, that there is a reasonable likelihood that a plan will benefit the fund and its shareholders.

The Commission also is adopting rule 17d-3 (17 CFR 270.17d-3) under the Act to provide an exemption from section 17(d) (15 U.S.C. 80a-17(d)) of the Act and rule 17d-1 (17 CFR 270.17d-1) thereunder, to the extent necessary, for agreements between a mutual fund and its affiliated persons whereby payments are made by the fund with respect to distribution, if such agreements are entered into in compliance with rule 12b-1. The Commission also is adopting certain disclosure and reporting requirements relating to use of assets for distribution, so that funds which bear distribution expenses in accordance with rule 12b-1 will disclose that fact to shareholders and prospective investors, as well as report it in registration statements filed with the Commission.

Background

In November, 1976, the Commission held public hearings on the use of fund assets for distribution.¹ After analyzing the comments and written submissions made at the hearings, the Commission reiterated its traditional view that it is generally improper under the Act for mutual funds to bear direct or indirect expenses related to the distribution of their shares.² However, the Commission has been reviewing the issue in light of public interest in and comment on the legal and policy implications of use of fund assets for distribution. In May, 1978, the Commission issued an Advance Notice of Proposed Rulemaking concerning conditions under which mutual funds might be permitted to bear distribution expenses.³ Release No. 10252 stated the Commission's belief that it would be useful to explore further whether permitting mutual funds to finance distribution could, under some circumstances, benefit investors. It also solicited public comment on a variety of proposed conditions upon such use of assets designed to safeguard the interests of investors.

The Commission reevaluated the issue of funds bearing distribution expenses in view of the comments received in

¹ The hearings were announced in Investment Company Act Release No. 9470 (Oct. 4, 1976) (41 FR 44770, Oct. 12, 1976) ("Release No. 9470"). Copies of the hearing transcripts and written submissions made in connection with the hearings are filed in File No. 4-186.

² Investment Company Act Release No. 9915 (Aug. 31, 1977) (42 FR 44810, Sept. 7, 1977).

³ Investment Company Act Release No. 10252 (May 23, 1978) (43 FR 23589, May 31, 1978) ("Release No. 10252").

response to Release No. 10252⁴ and in view of the philosophy and objectives of the Investment Company Act Study being conducted by the Division of Investment Management. The Commission concluded that there were a number of difficulties with some of the conditions proposed in Release No. 10252. Accordingly, in September, 1979, the Commission proposed for public comment rule 12b-1 under the Act.⁵ Generally, the proposed rule would make it unlawful for a mutual fund to finance distribution directly or indirectly except in compliance with the rule's substantive provisions. It would prescribe procedural requirements which are similar to those established by the Act for approval of investment advisory contracts, although the requirements of the proposed rule were more stringent. The substantive provisions of the proposed rule would place a great deal of responsibility on fund directors, especially the disinterested directors. The provisions were intended to insure that: (1) The disinterested directors would be free of domination or undue influence by management; (2) the directors would be fully informed and consider all relevant factors; and (3) the directors would exercise reasonable business judgment and would act in a manner consistent with their fiduciary duties.

Summary of Comments on Release No. 10862

Thirty-two comments were received on Release No. 10862.⁶ Twenty-two commentators, associated primarily with the mutual fund industry, submitted statements favoring the use of fund assets for distribution.⁷ Six

commentators argued against such use of fund assets,⁸ and one commentator refrained from taking any position on the propriety of a fund using its assets for distribution.⁹ In general, most commentators objected to at least some of the provisions of proposed rules 12b-1 and 17d-3. Several commentators also questioned some general statements made by the Commission in Release No. 10862.

Several commentators challenged the fundamental premises underlying the proposed rule. A common statement made by those in favor of using fund assets for distribution was that no Commission rule was necessary to enable funds to finance distribution.¹⁰ Instead, these commentators thought that directors could already authorize a fund to bear distribution expenses. Several commentators thought that the proposed rule would create uncertainty about purportedly well-established and current industry practice whereby the level of advisory fees reflects distribution expenses of the advisers.¹¹

Three of the commentators who opposed the use of fund assets for distribution concluded that withdrawal of the proposed rule and a reaffirmation of the Commission's traditional position was warranted because of the assertedly irreconcilable conflicts of interest of fund advisers and because the shareholder benefit would not be as discernible as that of advisers, since advisers clearly benefit from increased sales of fund shares.¹² Dreyfus and Federated, which also opposed using fund assets for distribution, thought that the proposed rule would destroy the entrepreneurial incentives provided by the Act. Dreyfus concluded that the additional responsibilities placed on the disinterested directors would improperly transform their role from one of supervision to one of management. Dreyfus questioned the ability of the disinterested directors to assume the management functions described in Release No. 10862. The board of

directors of a fund advised by Dreyfus and a disinterested director¹³ from that fund made similar comments individually.

Several commentators criticized the Commission's reliance on section 12(b) for rulemaking authority with respect to distribution and argued that Congress intended section 12(b) (15 U.S.C. 80a-12(b)) to authorize the Commission to adopt rules only where a fund distributed its own shares without an external underwriter.¹⁴ Instead, several submitted that any distribution rule with respect to funds which have principal underwriters should be promulgated only under section 15 of the Act.¹⁵

Some commentators, who argued in favor of permitting mutual funds to bear distribution expenses, urged the Commission to adopt the standard for decision-making by fund disinterested directors established by *Tannenbaum v. Zeller*, 552 F.2d 402 (2d Cir.), cert. denied, 434 U.S. 934 (1977), as the only legal requirement in the distribution area.¹⁶ In *Tannenbaum*, the Court of Appeals for the Second Circuit held that the disinterested directors of a fund did not breach their fiduciary duty to the fund in deciding to forgo recapture of brokerage commissions because: The directors were truly independent of the adviser; they were fully informed of all the available alternatives; and they had made a "reasonable business judgment" after thorough review of all relevant factors. Others would place responsibility with the entire board of directors and/or shareholders.¹⁷ The ABA urged that any rule adopted should apply only to those funds which knowingly elect to use fund assets for distribution purposes.

Two commentators suggested conditions governing use of fund assets for distribution that were, in some respects, similar to the proposed rule. Scudder would be sympathetic to a permissive rule if the independent directors of a fund concluded, acting in good faith, that a fund would benefit from sales expenditures by the fund, and if there was adequate disclosure to and consent by the shareholders. A disinterested director of Vanguard

⁴ The comments are summarized in Investment Company Act Release No. 10862 (Sept. 7, 1979) (44 FR 54014, Sept. 17, 1979) ("Release No. 10862").

⁵ Release No. 10862. Certain disclosure and reporting requirements relating to the use of fund assets for distribution were also proposed in Release No. 10862. In addition, the release contained proposed rule 17d-3 under the Act.

⁶ Copies of the comments are filed in File No. S7-743. Two comments were filed too late to be included in this summary. However, neither contained comments that had not already been made by the other commentators on the proposed rule.

⁷ American Bar Association ("ABA"), Capital Research and Management Company ("Capital Research"), The Fidelity Group of Mutual Funds ("Fidelity Group"), Fidelity Management and Research Company ("Fidelity Management"), Neil Flanagan, Gardner, Carton & Douglas ("Gardner"), Investment Company Institute ("ICI"), Investors Diversified Services, Inc. ("IDS"), Investors Group of Companies ("Investors Group"), Alice P. Jones ("Jones"), Jones & Babson, Inc. ("Babson"), Lord Abnett & Co. ("Lord Abnett"), Massachusetts Financial Services Company ("Mass. Financial"), John G. McDonald ("McDonald"), John R. Metcalf, National Association of Securities Dealers, Inc., Paine Webber Cashfund, Inc. ("Paine Webber"),

Pilgrim Management Corporation ("Pilgrim"), Charles D. Root, Jr. ("Root"), Scudder, Stevens & Clark ("Scudder"), The Vanguard Group of Investment Companies ("Vanguard"), and Waddell & Reed, Inc. ("Waddell").

⁸ American Bankers Association ("American Bankers"), The Dreyfus Corporation ("Dreyfus"), The Dreyfus Third Century Fund, Inc. ("Dreyfus Fund"), Federated Investors, Inc. ("Federated"), State of California, Department of Corporations ("Calif. Department of Corporations"), and Harold N. Warsawer ("Warsawer").

⁹ The Association of the Bar of the City of New York ("NYC Bar").

¹⁰ Capital Research, Fidelity Group, ICI, McDonald, and Waddell.

¹¹ ICI, NYC Bar, Paine Webber, and Waddell.

¹² American Bankers, Calif. Department of Corporations, and Warsawer.

¹³ Jones.

¹⁴ Gardner, ICI, Mass. Financial, Paine Webber, and Waddell.

¹⁵ ABA, ICI, Mass. Financial, and Waddell.

¹⁶ Gardner, ICI, IDS, and Lord Abnett.

¹⁷ Federated, Mass. Financial, and McDonald (director approval), and Babson (director and shareholder approval). In the context of responding specifically to the voting provisions of the proposed rule, several commentators, including some who preferred the *Tannenbaum* standard, supported the general concept of shareholder and director approval. Others opposed the requirements for shareholder approval. See pp. 13-14 *infra*.

thought that shareholder interests would be protected by independent directors exercising reasonable business judgments on distribution arrangements where: (1) The independent directors have no connection to or conflicts of interest with investment advisers, distributors, or any other organizations rendering services to the fund; (2) the independent directors are fully informed and represent a diversity of talent; (3) actual distribution expenses, whether paid directly or indirectly, are disclosed to shareholders; and (4) the independent directors review annually the long-term cost effectiveness and benefits to shareholders of any distribution expenses.

Commentators expressed some support for the statement in Release No. 10862 that there would be an indirect use of fund assets for distribution if the advisory fee was inflated to provide the adviser with funds for that purpose¹⁸ and agreement with the position that any rule on distribution should encompass both direct and indirect distribution expenses.¹⁹ In general, however, the commentators either criticized or were confused by the statement that distribution expenses include direct and indirect expenses primarily intended to result in the sale of shares of a fund. The ABA thought that directors should consider whether there is any indirect use of fund assets only if the directors previously made an express determination that a portion of the advisory fee would be used by the adviser to pay distribution expenses. Two commentators²⁰ thought that, to the extent approval of an underwriting contract which diverted a portion of investors' payments from the fund to the underwriter is deemed to be an indirect distribution expense, a fund and its directors could comply with section 15(b) of the Act (15 U.S.C. 80a-15(b)) and still violate the proposed rule. Others²¹ were uncertain whether the indirect bearing of distribution expenses was intended to be subject to the proposed rule. Two commentators²² urged that the concept of "indirect expenses" be deleted from the proposed rule.

Many commentators misconstrued the discussion in Release No. 10862 of the Commission's longstanding position that an adviser may use its "legitimate" or "not excessive" profits to finance distribution. In the opinion of several, such statements represented an

improper and unwarranted expansion of the fiduciary duty standard embodied in section 36(b) of the Act (15 U.S.C. 80a-35(b)).²³ A few commentators concluded that the proposed rule would establish a level of profit standard that was rejected by Congress in 1970, when Congress considered profit standards for investment advisory agreements but instead created the fiduciary duty standard under section 36 (15 U.S.C. 80a-35).²⁴ The ABA and the ICI thought that every externally managed fund would be forced to adopt the procedures within the proposed rule rather than risk a later determination that the adviser's profits were not legitimate and that the failure to adopt a plan resulted in a violation of the rule. Fidelity Management, on the other hand, thought that the rule would discourage an adviser from using any of its profits for distribution for fear of second guessing by the Commission.

Many of the specific conditions suggested by the Commission drew extensive criticism from the commentators. For example, several objected to the definition of distribution expenses, part of which included a non-exclusive list of activities that would be deemed distribution expenses. Instead, the commentators recommended that the definition be changed to recite precisely all activities that would be deemed distribution expenses.²⁵

Similarly, commentators criticized the requirement for two-thirds approval by shareholders and directors for the implementation of a distribution plan. They concluded that, since the potential for conflict in the decision whether a fund should bear distribution expenses would assertedly be no greater than the conflict involved in approving the advisory contract, a majority vote by shareholders and directors should be sufficient to approve a distribution plan,²⁶ and that there was no statutory basis for the more stringent voting requirements in the proposed rule.²⁷ Several commentators thought that it would be expensive²⁸ and difficult²⁹ for a fund to achieve such a high percentage of shareholder approval. Capital Research and Vanguard were of the opinion that, after the initial shareholder approval of a distribution plan, choice of

specific arrangements to be used from time to time should be within the discretion of the board of directors. Capital Research argued against requiring shareholder approval after each adjustment to the basic plan. Other commentators saw no need to require any shareholder approval for a distribution plan proposal.³⁰

Several commentators urged the Commission to eliminate the nominating committee requirement because they viewed it as unnecessary,³¹ founded on erroneous premises,³² inconsistent with the Act,³³ and creating additional problems.³⁴ Commentators also questioned the Commission's views in Release No. 10862 as to the possible lack of independence of independent directors, in light of the analysis by the Supreme Court in *Burks v. Lasker*, 99 S. Ct. 1831 (1979), concerning the role of disinterested directors.³⁵ Vanguard was the only commentator that expressly approved of the requirement that the selection and nomination of disinterested directors be committed to the discretion of the disinterested directors. Several commentators thought that, if the nominating committee concept is preserved in the proposed rule, interested directors should be allowed to participate in the nominating process.³⁶

With respect to the requirement that the directors weigh all pertinent factors before deciding to use fund assets for distribution, including a list of nine requisite factors, a majority of commentators on this point preferred the Commission to issue a release incorporating the nine factors.³⁷ In such a format, they contended, the directors could be made aware of their obligations to consider each factor without the rigidity that they feared would occur if the factors became mandatory provisions in a rule.

The standard of care required of directors in implementing a distribution plan was viewed with concern by some commentators, who thought the standard suggested that there may be fiduciary duties under state law or under the Act which are inconsistent

¹⁸ Fidelity Management, Lord Abbett, and Scudder.

¹⁹ Federated, Lord Abbett, and ICI.

²⁰ ABA, Federated, Fidelity Group, ICI, Paine Webber, and Pilgrim.

²¹ ABA, Federated, Fidelity Group, ICI, Mass. Financial, and NYC Bar.

²² Dreyfus Fund.

²³ ABA, Federated, Fidelity Group, ICI, and Paine Webber.

²⁴ ABA, Capital Research, and Fidelity Management.

²⁵ ABA, Fidelity Management, ICI, Investors Group, and Lord Abbett.

²⁶ ABA, Federated, IDS, and Waddell.

²⁷ Federated, NYC Bar, and Waddell.

²⁸ ABA, ICI, IDS, and NYC Bar.

²⁹ ABA, Capital Research, Federated, ICI, IDS, Investors Group, NYC Bar, Paine Webber, Pilgrim, Root, and Vanguard.

³⁰ Babson, Fidelity Management, Gardner, ICI, Mass. Financial, NYC Bar, and Waddell.

³¹ ABA, IDS, and Paine Webber.

³² ABA, Fidelity Management, Gardner, ICI, Lord Abbett, NYC Bar, and Paine Webber.

¹⁸ Lord Abbett.

¹⁹ Vanguard.

²⁰ Fidelity Management and Paine Webber.

²¹ Pilgrim and Vanguard.

²² Babson and Pilgrim.

with a business judgment standard.³⁸ Instead, these commentators joined Mass. Financial in the view that a business judgment standard alone would be appropriate when directors considered adopting a distribution plan.

Release No. 10862 stated that the proxy statement relating to a proposal to use fund assets for distribution would have to describe all material aspects of the plan and all material aspects of any agreements relating to implementation of the plan and it listed numerous disclosure items. The few comments that were received on this portion of the proposed rule generally supported the concept of full disclosure to investors.³⁹ The Fidelity Group concluded that meaningful disclosure would be the most practical check on excessive commitments of fund assets for distribution expenses. Fidelity Management, however, objected to the list of items in Release No. 10862 that were deemed to be required disclosure items because it was concerned that such a pattern of regulation could be expected to expand into other areas.

Release No. 10862 noted that the Commission has taken the preliminary position in the *Vanguard*⁴⁰ proceeding that a fund which bears distribution expenses but which does not charge a front end sales load cannot refer to itself as a "no-load" fund or use equivalent terminology. Release No. 10862 stated further that the Commission would not change its position at this time but that further consideration would be given to the "no-load" issue in connection with the *Vanguard* proceeding. Scudder, adviser to eight "no-load" funds, argued that, if the term "no-load" could be applied where a fund pays promotional expenses, the term would lose its meaning. On the other hand, a few commentators argued that there was no justification for the position taken in the *Vanguard* proceeding because the Act makes a distinction between a "sales load" and "sales or promotional expenses,"⁴¹ and because such a prohibition would not necessarily result in fair disclosure.⁴²

Commentators on proposed rule 17d-3 requested that the Commission clarify the effects of such a rule,⁴³ requested that the rule be expanded to encompass fund complexes,⁴⁴ and challenged the

Commission's asserted characterization of situations raising questions under section 17(d) of the Act.⁴⁵ The ICI and IDS objected to what they considered the Commission's position that funds with a common adviser, directors and/or officers are affiliated persons of one another. Paine Webber objected to what it viewed as the assumption in proposed rule 17d-3 that a traditional advisory or distribution agreement involving a single fund and its underwriter is subject to rule 17d-1. Federated and Vanguard argued that distribution services would be done most efficiently on a group-sharing basis and that proposed rule 17d-3 ignores the fact that fund complexes, rather than individual funds, dominate the industry. The ABA questioned whether the proposed rule would apply only with respect to a single fund within a complex, to funds not within a complex, or to several funds within a complex.

Discussion

After a thorough review of the comments on proposed rule 12b-1 and the companion rules, the Commission has decided to adopt the rules substantially as proposed in Release No. 10862. In response to the comments, however, the Commission has made certain modifications to proposed rule 12b-1, which are discussed below. Since there may be circumstances under which it would be appropriate for a fund to bear its distribution expenses, the Commission believes there should be some latitude for fund directors to exercise their business judgment to authorize such a use of fund assets. Nevertheless, the Commission still remains generally concerned about: (1) The conflicts which may exist between the interests of a fund and those of its investment adviser in deciding whether a fund should pay its distribution costs; (2) the likelihood that the fund will benefit from paying for such costs, and (3) the fairness to existing shareholders. Therefore, the Commission believes that any permissive rule in this area must contain substantive standards to protect fund shareholders, guidelines to ensure an orderly process of decision-making by directors, and accountability for exercising the authority to use fund assets for distribution. The Commission has concluded that proposed rule 12b-1, as modified, and its companion rules establish an appropriate regulatory balance and should be adopted. The Commission and its staff will monitor the operation of the rules closely and will be prepared to adjust the rules in light of experience to make the

restrictions on use of fund assets for distribution either more or less strict.

The Legal Authority To Adopt Proposed Rule 12b-1

Before proposing rule 12b-1 the Commission twice received public comment on its legal authority to regulate the direct or indirect use of fund assets for distribution. The release announcing the public hearings which were held in November, 1976, suggested as an issue for consideration: "What, if any, authority does the Commission have to adopt rules which would permit, prohibit, or limit the use of fund assets to pay distribution expenses?"⁴⁶ The Advance Notice of Proposed Rulemaking⁴⁷ stated that any ensuing rule proposal would be under section 12(b).

Relatively few of the presentations at the public hearings discussed the legal issues associated with the regulation of fund distribution expenses, but the prevalent view among those who did was that, although the Act did not necessarily prohibit the financing of distribution by funds, the Commission had the legal authority under the Act to prohibit or limit such activity. Of the 51 persons who commented on the Advance Notice, only three questioned the Commission's legal authority under section 12(b); only two argued affirmatively that the Commission lacks the authority to regulate expenditures by funds which have principal underwriters.

However, a significant number of the commentators on Release No. 10862 questioned the Commission's legal authority, so it is important to set forth fully the Commission's basis for relying primarily on section 12(b) for authority to regulate the use of fund assets for distribution.⁴⁸ Section 12(b) provides:

It shall be unlawful for any registered open-end company (other than a company complying with the provisions of section 10(d)) to act as a distributor of securities of

³⁸ Release No. 9470.

³⁹ Release No. 10252.

⁴⁰ It must be noted that the Commission is also relying on other sources of authority as well. Section 38(a) of the Act (15 U.S.C. 80a-37(a)) gives the Commission general authority to adopt rules "necessary or appropriate to the exercise of the powers conferred" elsewhere in the Act and specifically authorizes the Commission to define "accounting, technical, and trade terms" used in the Act. The latter phrase is significant because the term "distributor" in section 12(b) is not defined. In addition, section 17(d) of the Act authorizes the Commission to adopt rules regulating certain joint transactions involving investment companies and their affiliated persons and principal underwriters. The Commission is exercising its authority under section 17(d) to permit arrangements for use of fund assets for distribution which involve covered joint transactions only if such arrangements comply with rule 12b-1.

³⁸ ABA, Federated, and ICI.

³⁹ Fidelity Group, Fidelity Management, and Lord Abbett.

⁴⁰ For a full discussion of this issue, see *In Re The Vanguard Group, Inc.*, Initial Decision, Admin. Proc. File No. 3-5281, 21 (Nov. 29, 1978).

⁴¹ Paine Webber and Vanguard.

⁴² Gardner and Paine Webber.

⁴³ ABA.

⁴⁴ Federated, Root, and Vanguard.

⁴⁵ ICI, IDS, and Paine Webber.

which it is the issuer, except through an underwriter, in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Many commentators argued that the Commission has no authority under this provision to regulate the distribution financing activities of funds which have principal underwriters because of the phrase "except through an underwriter." Most of these commentators believed that other provisions of the Act, primarily section 15(b), govern the distribution efforts of funds which have principal underwriters. Some contended that the proposed rule was inconsistent with the basic statutory scheme regulating the relationships between funds and their investment advisers and principal underwriters established by sections 10 and 15 of the Act (15 U.S.C. 80a-10, 80a-15) because some of the procedural and substantive requirements of the proposed rule were more rigorous than similar provisions in the Act.

Section 12(b) was intended to permit the Commission to regulate the use of mutual fund assets to finance distribution. Commission spokesman David Schenker testified that the purpose of the section was to protect funds "against excessive sales, promotion expenses, and so forth."⁴⁹ The phrase "except through an underwriter" does not deprive the Commission of authority over the distribution financing activities of funds which have underwriters. If a fund finances distribution, it becomes so actively and intimately involved in the distribution process that, even if it contracts with an underwriter, it cannot fairly be said to be distributing through that underwriter. Such a fund should more properly be viewed as acting as a distributor along with the underwriter.

⁴⁹H.R. 10065, *Investment Trusts and Investment Companies: Hearings Before a Subcomm. of the House Comm. on Interstate and Foreign Commerce*, 76th Cong. 3d Sess. 112 (1940) (testimony of Commission spokesman David Schenker). H.R. 10065, which became law, embodied a compromise accepted both by the Commission and representatives of the investment company industry. (*Id.* at 15-16.) Shortly after passage of the Act, Alfred Jaretzki, who had participated in drafting the Act as a representative of closed-end companies, wrote about section 12(b):

[a]pparently the Commission was particularly fearful of the possibility that open-end investment companies in their formative stages might be made to shoulder the unprofitable burden of selling and distributing their shares during this period of heavy expenses and small return, building up the investment company for the benefit of some controlling person.

Jaretzki, *The Investment Company Act of 1940*, 26 Wash. U.L.Q. 303, 324-25 (1941) (footnote omitted).

Nevertheless, it is argued that section 15(b) of the Act is the exclusive source of authority to regulate the distribution arrangements of funds with underwriters. However, that section, in contrast to Section 12(b), provides no alternative mechanism for the regulation of fund expenditures to promote distribution. It would appear that section 15(b) is designed to regulate traditional underwriting arrangements, i.e., those where underwriters get their compensation from sales loads. Unlike section 15(a) (15 U.S.C. 80a-15(a)), Section 15(b) does not require any description of the compensation to be paid to the underwriter. This difference presumably exists because Congress did not expect funds to pay underwriters anything. It would appear that Congress sought to regulate under section 15(b) only distribution arrangements as it understood them to exist and did not contemplate the bearing of distribution expenses by funds which have underwriters. Therefore, it is inconsistent with the purposes of the Act to conclude that Section 15(b) is the exclusive source of regulation of fund expenditures to promote distribution.

General Requirements

Many commentators were critical of the inclusion of indirect distribution expenses within the scope of the rule. Some appeared confused about what might constitute indirect expenses, and others recommended that the rule apply only to direct expenditures. One commentator recommended that directors consider whether there is an indirect use of fund assets only if the directors made an express determination that part of the advisory fee would be used for fund distribution expenses. Accepting these recommendations would make evasion of the rule easy. The Commission has historically been concerned with whether funds are paying for distribution in substance and not with the form of particular arrangements. In this connection, it should be noted that section 48(a) of the Act (15 U.S.C. 80a-47(a)) in effect prohibits doing indirectly that which cannot be done directly. Therefore, the Commission believes that the rule should apply to indirect expenses as well as direct expenses.

However, in light of the uncertainty evinced by the commentators, some further explanation is in order. If a mutual fund makes payments which are earmarked for distribution, that is obviously a direct use of fund assets for distribution. If a fund makes payments which are ostensibly for some other purpose, and the recipient of those payments finances distribution, the

question arises whether the fund's assets are being used indirectly. The Commission's position has been and continues to be that there can be no precise definition of what types of expenditures constitute indirect use of fund assets. That judgment will have to be made based on the facts and circumstances of each individual case. Under proposed rule 12b-1, fund directors, particularly the disinterested directors, would bear substantial responsibility for making that judgment. Under sections 15(a) and (c) of the Act they are also responsible for evaluating and deciding whether to approve the advisory contract. In fulfilling these obligations directors of mutual funds would have to give careful scrutiny to any past, present or planned expenditures by the investment adviser for distribution, and determine on the basis of the facts of each particular case whether such expenditures constituted an indirect use of fund assets in violation of their fiduciary obligations under section 36 of the Act and in contravention of the rule. The Commission and its staff will continue to scrutinize arrangements which appear to involve the indirect use of fund assets for distribution.

Much of the confusion among the commentators arose from the description in Release No. 10862 of the effect proposed rule 12b-1 would have on advisers who bear the cost of distribution. Many commentators misconstrued the Commission's reaffirmation of its position that distribution financing activities by investment advisers do not necessarily involve an indirect use of fund assets. It is hoped that the following explanation will clarify the Commission's position. It is the Commission's view that, an indirect use of fund assets result if any allowance is made in the adviser's fee to provide money to finance distribution. Therefore, when an adviser finances distribution, fund directors, in discharging their responsibilities in connection with approval of the advisory contract, must satisfy themselves either that the management fee is not a conduit for the indirect use of the fund's assets for distribution or that the rule has been complied with. However, under the rule there is no indirect use of fund assets if an adviser makes distribution related payments out of its own resources. In determining whether there is an indirect use of fund assets, it is appropriate to relate a fund's payments pursuant to the advisory contract to the adviser's expenditures for distribution and to view such expenditures as having been made from

the adviser's profits, if any, from the advisory contract. To the extent that such profits are "legitimate" or "not excessive", the adviser's distribution expenses are not an indirect use of fund assets. Many commentators drew unwarranted inferences from the use of "legitimate" and "not excessive" in Release No. 10862. Profits which are legitimate or not excessive are simply those which are derived from an advisory contract which does not result in a breach of fiduciary duty under section 36 of the Act. The courts have not established definitive standards for determining what does or does not constitute a breach of fiduciary duty in the compensation area, and, although the Commission reserves the right to express its own views of what such standards should be, it has not done so.

Some commentators suggested that the definition of distribution expenses recite precisely all activities that would be deemed distribution expenses. Recognizing that new distribution activities may continuously evolve in the future, and in view of the impracticability of developing an all-inclusive list, the Commission maintains that the better approach is to define distribution expenses in conceptual terms (e.g., financing activities primarily intended to result in the sale of fund shares).

Procedural Requirements

The Commission has reevaluated the requirement in the proposed rule for two-thirds approval by shareholders in light of comments about the practical difficulties funds anticipated in getting sufficient shareholder participation, as distinct from approval, to meet the two-thirds requirement. Consequently, the rule, as adopted, requires only a majority shareholder vote. The Commission believes that the approval requirements, including the requirement of director approval, are sufficient to protect adequately shareholder interests in deciding whether it is necessary or appropriate for a fund to bear its distribution expenses. In addition, the Commission does not believe it is necessary to impose the extraordinary requirement that two-thirds of the disinterested directors and of the board as a whole approve the use of fund assets for distribution. It is not clear that the practical effect of such a requirement would justify deviation from the normal requirement of a majority vote, especially since in most cases it would require the support of as many disinterested directors to achieve a majority vote as it would to achieve a two-thirds vote.

The rule has also been amended to clarify that, subsequent to the adoption of a distribution plan, only modifications which would materially increase the amount of money to be spent need be submitted to the shareholders for approval. Moreover, agreements pursuant to a plan will not be subjected to a shareholder vote. The Commission recognizes that once a distribution plan has been approved in the manner prescribed in the rule, directors should be allowed some discretion to modify agreements with the providers of distribution services as the circumstances change.

Independence of Directors

Permitting the use of fund assets for distribution is a major regulatory change for the Commission. This change reflects both altered circumstances and a determination by the Commission that adoption of rule 12b-1 is appropriate in light of the regulatory reform objectives of the Investment Company Act Study. Two central goals of the Study are to permit investment companies to exercise wider latitude in making business judgments without Commission approval and to enhance the role of directors, particularly the disinterested directors, in scrutinizing investment company affairs. These goals are interdependent in that the more capable the disinterested directors are of overseeing the kinds of activities of investment companies which are of regulatory significance, the more the Commission will be willing to reduce regulatory restrictions.

The Commission views a decision to use fund assets for distribution as a particularly difficult business judgment which is complicated by the conflicts of interest which are present. Since rule 12b-1 does not restrict the kinds or amounts of payments which could be made, the role of the disinterested directors in approving such expenditures is crucial. No formal provisions in a rule can insure that directors will make the right decision in every instance; however, the likelihood that a decision will be in the best interests of a fund and its shareholders will be increased if the disinterested directors are genuinely independent of management. Of course, a requirement that the tenure of disinterested directors be independent of management control will not guarantee that disinterested directors will in fact be independent. Nevertheless, experience indicates that such formal independence will breed an atmosphere in which actual independence will develop. The well-documented trend among corporations generally toward director independence

(e.g., the increasing number of boards which have independent majorities and majority independent committees, including nominating committees) strongly implies a recognition of the validity of this proposition. Accordingly, the Commission believes that, in order for rule 12b-1 to be effective, disinterested directors must be independent.

The Commission remains concerned that there will be situations in which disinterested directors may not be able to act with complete independence in deciding whether to use fund assets for distribution because of the possibility that the advisers' control over the funds they advise could lead to domination of or undue influence over the disinterested directors. The Commission recognizes that many advisers who control the funds they advise would not attempt to misuse such control over the disinterested directors and that many disinterested directors are fully independent. However, the Commission still believes that it is appropriate to enhance the independence of disinterested directors by adopting the provisions of paragraph (c) as proposed. This belief reflects the cumulative experience of the staff in regulating the mutual fund industry and, for that reason, citations of such cases as *Burks v. Lasker*⁵⁰ are not apposite. Whatever *Burks* or *Tannenbaum* may have said about the theoretical role of disinterested directors or about the actual independence of the directors who were involved in those cases, it is the Commission's view that as a general proposition disinterested directors should not be entrusted with a decision on use of fund assets for distribution without receiving the benefit of measures designed to enhance their ability to act independently.

With respect to the argument that paragraph (c) is extra statutory, the Commission acknowledges that there are no identical provisions in the Investment Company Act, although

⁵⁰ 99 S. Ct. 1831. In *Burks* the Supreme Court held, in part, that the Act did not forbid disinterested directors from terminating non-frivolous law suits. In that case, the Court did not pronounce generally that under all circumstances disinterested directors are able to act with genuine independence. Instead, the court recognized that because of the potential conflicts, "some restraints upon the unfettered discretion of even disinterested mutual fund directors, particularly in their transactions with the investment adviser" may be justified (at 1839). Although the Commission does not view the measures in the rule which will enhance the independence of disinterested directors to be restraints upon such directors, the Commission believes that such measures, in the context of a permissive rule to allow funds to pay distribution expenses, are consistent with the Supreme Court's caution concerning the role of disinterested directors and are necessary and appropriate.

section 15(f) contains provisions of similar import.⁵¹ Nevertheless, the Commission believes that paragraph (c) is a reasonable restriction. That provision does not impose a new regulatory requirement on all investment companies; instead it makes available an exemption from regulation for companies which elect to institute a corporate governance mechanism which, as suggested above, is consistent with salutary developments among corporations of all types.

Factors

In order to avoid the appearance of either unduly constricting the directors' decision making process or of creating a mechanical checklist, the Commission has decided to delete the list of factors from rule 12b-1. However, in order to insure a proper record of the deliberative process, the rule will require preservation of minutes. Since corporate minutes are frequently cryptic, the rule requires explicitly that these minutes set forth the factors the directors considered, together with an explanation of the basis for the decision to sue fund assets for distribution.

Although the Commission has decided not to require directors to consider any particular factors, the Commission believes that the factors enumerated in rule 12b-1 would normally be relevant to a determination of whether to use fund assets for distribution. Therefore, it appears that setting forth those factors in this release may provide helpful guidance to directors. The following list of factors is the same as the list contained in proposed rule 12b-1, except for slight amplification of the fourth factor:

(1) Consider the need for independent counsel or experts to assist the directors in reaching a determination;

(2) Consider the nature of the problems or circumstances which purportedly make implementation or continuation of such a plan necessary or appropriate;

(3) Consider the causes of such problems or circumstances;

(4) Consider the way in which the plan would address these problems or circumstances and how it would be expected to resolve or alleviate them, including the nature and approximate amount of the expenditures; the relationship of such expenditures to the overall cost structure of the fund; the nature of the anticipated benefits, and the time it would take for those benefits to be achieved;

⁵¹ Section 15(f) requires, inter alia, that the board be three-fourths disinterested for three years after a sale of an interest in the investment adviser resulting in assignment of the advisory contract.

(5) Consider the merits of possible alternative plans;

(6) Consider the interrelationship between the plan and the activities of any other person who finances or has financed distribution of the company's shares, including whether any payments by the company to such other person are made in such a manner as to constitute the indirect financing of distribution by the company;

(7) Consider the possible benefits of the plan to any other person relative to those expected to inure to the company;

(8) Consider the effect of the plan on existing shareholders; and

(9) Consider, in the case of a decision on whether to continue a plan, whether the plan has in fact produced the anticipated benefits for the company and its shareholders.

Reasonable Business Judgment

The Commission is adopting the standard of care required of directors in implementing a distribution plan as proposed originally in Release No. 10862. The Commission intentionally did not define the relationship between a "reasonable business judgment" and "fiduciary duties" under state law and under sections 36 (a) and (b) of the Act, nor did it define those director activities that would be consistent with each concept. The Commission did this in recognition that the concepts are constantly evolving and, particularly, that there have been no comprehensive or definitive interpretations of the various fiduciary duty requirements of section 36. Certainly it was not the Commission's intent to assert any such interpretation of its own. Rather, as stated clearly in Release No. 10862, paragraph (e) incorporates directors' existing duties in order to emphasize that formal compliance with the other provisions of the rule will not establish a safe harbor. The Commission believes that the standards for accountability placed on the directors concerning their decision to implement a distribution plan are necessary and are consistent with the standards under the Act and under state law required of fund directors in other decision making contexts.

Disclosure and Reporting Requirements

The Commission is adopting the disclosure and reporting requirements substantially as proposed in Release No. 10862 for the reasons stated in that release.⁵² As noted above, the few comments that were received on the

⁵² The Commission has slightly amended proposed new Item 9, Part II, Form N-1 (17 CFR 239.15, 274.11) in order to facilitate monitoring of expenditures for distribution.

disclosure and reporting requirements generally supported the concept of full disclosure to investors. Moreover, the Commission continues to believe that it is inappropriate, at this time, to modify the position taken in the *Vanguard* proceeding that a fund which bears distribution expenses but which does not charge a front-end sales load cannot refer to itself as a "no-load" fund or use equivalent terminology. Instead, the Commission remains of the opinion that it is more appropriate to give further consideration to this issue within the context of the *Vanguard* proceeding.

Proposed Rule 17d-3

The Commission is adopting rule 17d-3 as proposed in Release No. 10862. One commentator asked whether the rule 17d-3 exemption would apply to several funds within a complex. Each fund within a complex can make individual and independent determinations, in accordance with the provisions of rule 12b-1, to bear its own distribution expenses. To the extent that each fund independently decides to bear its own distribution expenses, and to the extent that the provisions of section 17(d) and rule 17d-1 would otherwise apply, the exemption under rule 17d-3 is available. However, the Commission remains of the opinion that it would be inappropriate, in view of the *Vanguard* proceeding, to extend rule 17d-3 to arrangements for the joint sharing of distribution costs by funds which are affiliates (or affiliates of affiliates) of each other. The Commission wished to emphasize that it has no intention of categorizing certain transactions as raising the applicability of section 17(d) and rule 17d-3 of the Act. The Commission's only comment is that, to the extent that arrangements in which a fund pays for its distribution costs would involve the fund in a "joint enterprise" with an affiliated person, and if such arrangements were entered into in compliance with rule 12b-1, the Commission sees no need for prior Commission review and approval of the arrangements.

Authority, Effective Date

The Commission, pursuant to section 12(b) (15 U.S.C. 80a-12(b)), and section 38(a) (15 U.S.C. 80a-37(a)) of the Act hereby amends 17 CFR Part 270 by adding new § 270.12b-1. Further, the Commission pursuant to section 17(d) (15 U.S.C. 80a-17(d)) and 38(a) of the Act hereby amends 17 CFR Part 270 by adding new § 270.17d-3. Finally, the Commission is amending 17 CFR Part 239 and 17 CFR Part 274 by amending § 239.15 and § 274.11, pursuant to sections 6, 7, 8, 19, and 19(a)

of the Securities Act of 1933 (15 U.S.C. 77f, 77g, 77h, 77j, and 77s(a)), and sections 8 (15 U.S.C., 80a-8) and 38(a) of the Act. This action is effective immediately pursuant to the Administrative Procedure Act (15 U.S.C. 553(d)(1)).

I. Chapter II of Title 17 of the Code of Federal Regulations is amended as follows:

PART 270—RULES AND REGULATIONS, INVESTMENT COMPANY ACT OF 1940

1. Adding a new § 270.12b-1 as follows:

§ 270.12b-1 Distribution of shares by registered open-end management investment company.

(a)(1) Except as provided in this section, it shall be unlawful for any registered open-end management investment company (other than a company complying with the provisions of section 10(d) of the Act (15 U.S.C. 80a-10(d))) to act as a distributor of securities of which it is the issuer, except through an underwriter.

(2) For purposes of this section, such a company will be deemed to be acting as a distributor of securities of which it is the issuer, other than through an underwriter, if it engages directly or indirectly in financing any activity which is primarily intended to result in the sale of shares issued by such company, including, but not necessarily limited to, advertising, compensation of underwriters, dealers, and sales personnel, the printing and mailing of prospectuses to other than current shareholders, and the printing and mailing of sales literature.

(b) A registered, open-end management investment company ("Company") may act as a distributor of securities of which it is the issuer: *Provided*, That any payments made by such company in connection with such distribution are made pursuant to a written plan describing all material aspects of the proposed financing of distribution and that all agreements with any person relating to implementation of the plan are in writing: *And further provided*, That:

(1) Such plan has been approved by a vote of at least a majority of the outstanding voting securities of such company;

(2) Such plan, together with any related agreements, has been approved by a vote of the board of directors of such company, and of the directors who are not interested persons of the company and have no direct or indirect financial interest in the operation of the plan or in any agreements related to the

plan, cast in person at a meeting called for the purpose of voting on such plan or agreements; and

(3) Such plan or agreement provides, in substance:

(i) That it shall continue in effect for a period of more than one year from the date of its execution or adoption only so long as such continuance is specifically approved at least annually in the manner described in paragraph (b)(2) of this section;

(ii) That any person authorized to direct the disposition of monies paid or payable by such company pursuant to the plan or any related agreement shall provide to the company's board of directors, and the directors shall review, at least quarterly, a written report of the amounts so expended and the purposes for which such expenditures were made; and

(iii) In the case of a plan, that it may be terminated at any time by vote of a majority of the members of the board of directors of the company who are not interested persons of the company and have no direct or indirect financial interest in the operation of the plan or in any agreements related to the plan or by vote of a majority of the outstanding voting securities of such company; and

(iv) In the case of an agreement related to a plan, (A) That it may be terminated at any time, without the payment of any penalty, by vote of a majority of the members of the board of directors of such company who are not interested persons of the company and have no direct or indirect financial interest in the operation of the plan or in any agreements related to the plan or by vote of a majority of the outstanding voting securities of such company on not more than sixty days' written notice to any other party to the agreement, and

(B) For its automatic termination in the event of its assignment; and

(4) Such plan provides that it may not be amended to increase materially the amount to be spent for distribution without shareholder approval and that all material amendments of the plan must be approved in the manner described in paragraph (b)(2) of this section;

(5) Such plan is implemented and continued in a manner consistent with the provisions of paragraphs (c), (d), and (e) of this section;

(c) A registered open-end management investment company may rely on the provisions of paragraph (b) of this section only if selection and nomination of those directors who are not interested persons of such company are committed to the discretion of such disinterested directors;

(d) In considering whether a registered open-end management investment company should implement or continue a plan in reliance on paragraph (b) of this section, the directors of such company shall have a duty to request and evaluate, and any person who is a party to any agreement with such company relating to such plan shall have a duty to furnish, such information as may reasonably be necessary to an informed determination of whether such plan should be implemented or continued; in fulfilling their duties under this paragraph the directors should consider and give appropriate weight to all pertinent factors, and minutes describing the factors considered and the basis for the decision to use company assets for distribution must be made and preserved in accordance with paragraph (f) of this section;

Note.—For a discussion of factors which may be relevant to a decision to use company assets for distribution, see Investment Company Act Releases Nos. 10862, September 7, 1979, and 11414, October 28, 1980.

(e) A registered open-end management investment company may implement or continue a plan pursuant to paragraph (b) of this section only if the directors who vote to approve such implementation or continuation conclude, in the exercise of reasonable business judgment and in light of their fiduciary duties under state law and under sections 36(a) and (b) (15 U.S.C. 80a-35 (a) and (b)) of the Act, that there is a reasonable likelihood that the plan will benefit the company and its shareholders; and

(f) A registered open-end management investment company must preserve copies of any plan, agreement or report made pursuant to this section for a period of not less than six years from the date of such plan, agreement or report, the first two years in an easily accessible place.

2. Adding a new § 270.17d-3 as follows:

§ 270.17d-3 Exemption relating to certain joint enterprises or arrangements concerning payment for distribution of shares of a registered open-end management investment company.

An affiliated person, of, or principal underwriter for, a registered open-end management investment company and an affiliated person of such a person or principal underwriter shall be exempt from section 17(d) of the Act (15 U.S.C. 80a-17(d)) and rule 17d-1 thereunder (17 CFR 270.17d-1), to the extent necessary to permit any such person or principal underwriter to enter into a written

agreement with such company whereby the company will make payments in connection with the distribution of its shares, *Provided, That:*

(a) Such agreement is made in compliance with the provisions of § 270.12b-1; and

(b) No other registered management investment company which is either an affiliated person of such company or an affiliated person of such a person is a party to such agreement.

II. Chapter II of Title 17 of the Code of Federal Regulations is amended as follows:

PART 239—FORMS PRESCRIBED UNDER THE SECURITIES ACT OF 1933

PART 274—FORMS PRESCRIBED UNDER THE INVESTMENT COMPANY ACT OF 1940

1. By adding new Item 1(b)(15), Part II of Form N-1 as follows:

§ 239.15 Form N-1 for open-end management investment companies registered on Form N-8A.

§ 274.11 Form N-1, registration statement of open-end management investment companies.

Item 1. Financial Statements and Exhibits.

(b) Exhibits:

(15) copies of any plan entered into by Registrant pursuant to rule 12b-1 under the 1940 Act, which describes all material aspects of the financing of distribution of Registrant's shares, and any agreements with any person relating to implementation of such plan.

2. By adding new Item 9, Part II, of Form N-1 and renumbering current Item 9 in Part II as Item 10:

§ 239.15 Form N-1 for open-end management investment companies registered on Form N-8A.

§ 274.11 Form N-1, registration statement of open-end management investment companies.

Item 9. Distribution Expenses.

Furnish a summary of the material aspects of any plan pursuant to which the Registrant incurs expenses related to the distribution of its shares, and of any agreements related to the implementation of such a plan. The summary should include, among other material information, the following:

(a) The amounts paid by the Registrant under the plan during the last fiscal year, as a total dollar amount and a percentage of Registrant's average net assets during that period;

(b) The manner in which such amount was spent on:

(i) Advertising,

(ii) Printing and mailing of prospectuses to other than current shareholders,

(iii) Compensation to underwriters,

(iv) Compensation to dealers,

(v) Compensation to sales personnel, and

(vi) Other (specify).

(c) Whether any of the following persons had a direct or indirect financial interest in the operation of the plan or related agreements:

(i) Any interested person of the Registrant; or

(ii) Any director of the Registrant who is not an interested person of the Registrant.

(d) The benefits, if any, to the Registrant resulting from the plan.

Instruction: In responding to this item the Registrant should take note of the requirements of rule 12b-1 under the 1940 Act (17 CFR 270.12b-1).

By the Commission.

George A. Fitzsimmons,
Secretary.

October 28, 1980.

[FR Doc. 80-34788 Filed 11-6-80; 8:45 am]

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17 CFR Parts 240 and 249

[Release No. 34-17258, File No. S7-590]

Filings by Self-Regulatory Organizations of Proposed Rule Changes and Other Materials with the Commission

AGENCY: Securities and Exchange Commission.

ACTION: Final rules and form; revocation of rule and form.

SUMMARY: The Commission is amending the requirements applicable to the filing by self-regulatory organizations of proposed rule changes and certain other materials. The amendments, which are intended to facilitate the review of proposed rule changes, (i) specify in greater detail the information required in a filing; (ii) expand the categories of proposed rule changes that may become effective summarily to include certain rules effecting changes in existing services of registered clearing agencies; and (iii) clarify which actions of self-regulatory organizations are proposed rule changes. In addition, the Commission is revoking the requirement that self-regulatory organizations file stated policies, practices, and interpretations not deemed to be rules. The Commission is also revoking requirements that each national securities exchange or registered securities association file separately information about its rules in effect on June 4, 1975, and certain forms, reports, or questionnaires. Finally, the Commission is adopting a rule requiring registered clearing agencies to file

material they make generally available. The Commission is withdrawing, in a separate release, proposals relating to these matters.

EFFECTIVE DATE: January 1, 1981.

FOR FURTHER INFORMATION CONTACT:

Susan Davis, Esq., (202) 272-2828; or Jeffrey Jordan, Esq., (202) 272-2847, Division of Market Regulation, Securities and Exchange Commission, Washington, D.C. 20549.

SUPPLEMENTARY INFORMATION: The Securities and Exchange Commission today announced the following action with respect to proposals in its May 1979 release ¹ (the "Proposal Release") to facilitate review of proposed rule changes of self-regulatory organizations under Section 19(b) ² of the Securities Exchange Act of 1934 (the "Act"); ³

(1) Adoption of amendments to Rule 19b-4 under the Act;⁴

(A) Clarifying which actions of a self-regulatory organization constitute proposed rule changes,

(B) Providing summary effectiveness for certain rules changing existing services of registered clearing agencies,

(C) Eliminating the requirement that a self-regulatory organization file on Form 19b-4B ⁵ notice of stated policies, practices, and interpretations not deemed to be rules, and

(D) Eliminating the requirement that each national securities exchange and registered securities association file information about its rules in effect on June 4, 1975.

¹ Securities Exchange Act Release No. 15838 (May 18, 1979), 44 FR 30924 (May 29, 1979). The Commission received comments in response to the Proposal Release from the American Stock Exchange, Inc. ("Amex"), Chicago Board Options Exchange, Inc. ("CBOE"), Depository Trust Company ("DTC"), Municipal Securities Rulemaking Board ("MSRB"), National Association of Securities Dealers, Inc. ("NASD"), National Securities Clearing Corporation ("NSCC"), New York Stock Exchange, Inc. ("NYSE"), and Options Clearing Corporation ("OCC"). Securities and Exchange Commission File No. S7-590 ("File No. S7-590").

² 15 U.S.C. 78s(b). Section 19(b) requires a self-regulatory organization to file with the Commission each of its proposed rule changes, accompanied by a concise general statement of the basis and purpose of the proposed rule change. A proposed rule change cannot take effect unless the Commission approves it, or it is otherwise permitted to become effective under Section 19(b). To approve a proposed rule change, the Commission must find that the rule change is consistent with the requirements of the Act and the rules and regulations thereunder applicable to the self-regulatory organization proposing the rule change.

³ 15 U.S.C. 78a et seq.

⁴ 17 CFR 240.19b-4. Rule 19b-4 was adopted in August 1975. Securities Exchange Act Release No. 11604 (Aug. 19, 1975), 40 FR 40509 (Sept. 3, 1975).

⁵ 17 CFR 249.819b.

(2) Adoption of amendments to Form 19b-4A⁶ and redesignation of Form 19b-4A as Form 19b-4.

(3) Revocation of Form 19b-4B, on which notice is filed of stated policies, practices, and interpretations not deemed to be rules.

(4) Revocation of Rule 17a-18,⁷ which requires national securities exchanges and registered securities associations to file new or substantially modified forms, reports, or questionnaires.

(5) Adoption of Rule 17a-22⁸ requiring registered clearing agencies to file materials they issue or make generally available.

(6) Withdrawal of proposed amendments to Rule 19b-4 and Form 19b-4A that would have provided summary effectiveness for certain proposed rule changes of self-regulatory organizations circulated, for pre-filing review, to the Commission and to persons who would be subject to the rules.

(7) Withdrawal of proposed Rule 3b-7, which would have defined the term "rule" of a self-regulatory organization for purposes of Sections 3(a)(27) and 3(a)(28) of the Act.⁹

The Commission's actions announced today¹⁰ are intended to facilitate the review of proposed rule changes of self-regulatory organizations¹¹ and are designed to complement the Commission's ongoing program to improve the review process.¹² The self-regulatory organizations have also undertaken efforts to improve the review process and have substantially assisted the Commission in its efforts in this area. Continued cooperation and communication between the Commission and the self-regulatory organizations is essential to the efficient administration of Section 19(b).

The Commission's actions are discussed in detail in the remainder of

this release,¹³ which consists of the following sections:

- I. Amendments to Form 19b-4.
- II. Expansion of categories of proposed rule changes that may become effective on filing.
- III. Self-regulatory organization actions constituting proposed rule changes.
- IV. Revocation of certain filing requirements; adoption of rule 17a-22 concerning registered clearing agencies.
- V. Statutory basis.
- VI. Text of rules and form.

I. Amendments to Form 19b-4

A major problem the Commission has encountered in administering Section 19(b) is that many proposed rule change filings have not provided an adequate basis for Commission review. As a result, the Commission's staff has had to devote considerable time and resources to obtaining from self-regulatory organizations necessary information not provided in the filings, thereby delaying the rule review process. To avoid such delays, the Commission proposed amendments to Form 19b-4A designed to elicit the information necessary for it to review proposed rule changes promptly and efficiently. The Commission is adopting the proposed amendments with the modifications described below and is redesignating Form 19b-4A as Form 19b-4.

A. Instruction B. Need for Careful Preparation of the Completed Form, Including Exhibits

The Commission proposed a new Instruction B to Form 19b-4 emphasizing that the information required by the form is necessary for the Commission to determine whether, as required by Section 19(b) of the Act, a proposed rule change is consistent with the Act and the rules and regulations thereunder. Instruction B also makes clear that any filing not in compliance with the requirements of the form may be returned to the self-regulatory organization at any time before issuance of the notice of filing.

Commentators expressed concern that Instruction B would permit the Commission or its staff to return filings on the basis of substantive objections.¹⁴ Instruction B, however, does not contemplate that filings will be returned for reasons other than failure to comply with the requirements of the form.

Another commentator stated that Instruction B could exacerbate pre-filing

delays unless the Commission established a limit on the time for determining whether a filing is deficient.¹⁵ The Commission intends to publish notices of filing promptly. Since prompt publication of the notices will effectively reduce pre-filing delays, the Commission believes that establishing further limits on the time for pre-filing review is unnecessary.

The Commission believes that the information provided on Form 19b-4 must be adequate to support a Commission finding that a proposed rule change is consistent with the Act and applicable rules and regulations.¹⁶ Returning deficient filings permits the Commission and its staff to focus on filings that provide an adequate basis for review. Accordingly, the Commission is adopting Instruction B, as proposed, with only editorial changes.

B. Instruction D. Amendments

Instruction D prescribes requirements for amending rule change filings. The Commission proposed certain amendments to the instruction, including requirements to indicate changes, if any, made from the preceding filing and from existing rules of the self-regulatory organization.

One commentator stated that when amending a filing the self-regulatory organization should not be required to submit the entire text of a lengthy rule in order to alter, for example, only one page of the text.¹⁷ The Commission agrees that the filing requirement should afford some flexibility in that regard and has revised the instruction to provide that if the self-regulatory organization is amending only part of the text of a lengthy proposed rule change, it may file only those portions of the text in which amendments are made if the filing is clearly understandable on its face.

Instruction D has also been revised in several other respects. First, it has been revised to make clear that the self-regulatory organization must file, in accordance with Instruction F, copies of any correspondence or other communications reduced to writing (including comment letters) to and from the self-regulatory organization that it prepares or receives on a proposed rule change after the rule change is filed with the Commission but before the Commission takes final action on it. Second, Instruction D has been revised to provide that if information in such a communication makes the rule change filing inaccurate, the filing must be amended to correct the inaccuracy.

⁶ 17 CFR 249.819a.

⁷ 17 CFR 240.17a-18.

⁸ 17 CFR 240.17a-22.

⁹ 15 U.S.C. 78c(a)(27), 78c(a)(28).

¹⁰ In accordance with Section 17A(d)(3)(A)(i) of the Act, 15 U.S.C. 78q-1(d)(3)(A)(i), at least fifteen days before this announcement, the Commission consulted and requested the views of the Board of Governors of the Federal Reserve System.

¹¹ Rule 19b-4 applies only to proposed rule changes of self-regulatory organizations. The Commission has proposed a separate rule under the Act, proposed Rule 11Aa3-2, which would establish procedures relating to plans governing the planning, developing, operating or regulating of a national market system, or one or more facilities thereof. See Securities Exchange Act Release No. 16410 (Dec. 7, 1979), 44 FR 72607 (Dec. 14, 1979).

¹² Each year since 1975 the Commission has received approximately three hundred filings of proposed rule changes and stated policies, practices, and interpretations not deemed to be rules.

¹³ The withdrawal of proposed Rule 3b-7 and certain proposed amendments to Rule 19b-4 and Form 19b-4A is the subject of a brief companion release also issued today, Securities Exchange Act Release No. 17259 (October 30, 1980) (the "Companion Release").

¹⁴ DTC, NASD, and NYSE Responses, File No. S7-590.

¹⁵ Amex Response, File No. S7-590.

¹⁶ See text accompanying n. 24, *infra*.

¹⁷ NASD Response, File No. S7-590.

Third, it has been revised to describe more clearly the manner in which changes made by the amendment are to be marked. Finally, the instruction has been revised to provide that the self-regulatory organization is required to explain the purpose of the amendment and, if the amendment changes the purpose of the proposed rule change, it is also required to provide a revised statement of the purpose of the proposed rule change.¹⁸

C. Instruction E. Completion of Action by the Self-Regulatory Organization on the Proposed Rule Change

Instruction E provides that if the self-regulatory organization files a proposed rule change before it has completed all action necessary for internal approval of the change, it must consent to an extension of time until at least thirty-five days after the self-regulatory organization files an amendment stating that it has completed action on the rule change. One commentator stated that the requirement is unnecessarily rigid.¹⁹ The commentator suggested that the instruction should provide for extensions of up to thirty-five days, to be negotiated as circumstances warrant.

In most instances, after the self-regulatory organization files an amendment stating that it has completed action on the proposed rule change, the Commission requires thirty-five days to complete its review. Where the Commission completes its review before expiration of the thirty-five day period, it can accelerate effectiveness of the rule change.²⁰ Accordingly, the Commission is adopting Instruction E without the suggested amendment.

D. Item 1. Text of the Proposed Rule Change

Paragraph (a) of Item 1 requires the self-regulatory organization to set forth the text of the proposed rule change. The Commission proposed to amend paragraph (a) to require the self-regulatory organization to submit any

existing form, report, or questionnaire that is directly related to a proposed rule change. A number of self-regulatory organization rules are implemented through prescribed forms, reports, or questionnaires not set forth in the text of the rules published by the self-regulatory organization. In considering such rules, the Commission reviews the related forms, reports, or questionnaires. Accordingly, to expedite the review process, the Commission is adopting the amendment to Item 1(a) as proposed.

Paragraph (b) of Item 1 of Form 19b-4A as originally adopted requires the self-regulatory organization to set forth the text of any rules the application of which is affected, directly or indirectly, by the proposed rule change. In response to comments that that requirement was overly burdensome, the Commission proposed to amend paragraph (b) to require that the designation or title, rather than the text, of such rules be provided.

One commentator suggested that the Commission revise paragraph (b) to delete the requirement that the self-regulatory organization list those rules that the proposed rule change affects indirectly.²¹ The commentator stated that the requirement is unwieldy and burdensome because indirect effects cannot be predicted fully and accurately.

The Commission does not intend to require the self-regulatory organization to predict every effect a proposed rule change could have on the organization's existing rules. Rather, the Commission intends to require the self-regulatory organization merely to identify those rules on which the organization reasonably expects the proposed rule change to have direct or significant indirect effects. Accordingly, the Commission has revised the amendment to Item 1(b) to make that intent clear.

E. Item 2. Procedures of the Self-Regulatory Organization

Item 2 requires the self-regulatory organization to describe action on the proposed rule change taken by its members or board of directors or other governing body. The Commission proposed to amend Item 2 to require the self-regulatory organization to provide the name and telephone number of the staff member prepared to respond to questions and comments on the proposed rule change. The Commission has revised the amendment, in light of a suggestion made by one commentator,²² to provide for instances where different persons at the self-regulatory

organization are best prepared to discuss different aspects of the proposal.

F. Item 3. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

Item 3 of Form 19b-4A as originally adopted requires a statement of the purpose of a proposed rule change, and Item 4 requires a statement of its basis under the Act. The Commission proposed to combine the statements of purpose and basis. The Commission also proposed amendments to specify in detail the information required in the statement, making clear that the statement should be sufficiently detailed and specific to support a Commission finding under Section 19(b) that the proposed rule change is consistent with the Act and rules and regulations thereunder. Several commentators objected to proposed Item 3, contending that the required statement either is unnecessary or exceeds the Section 19(b)(2) requirement for a "concise" statement.²³

The statement of purpose and basis must be sufficient to support a finding by the Commission that a proposed rule change is consistent with the Act and rules and regulations thereunder. The Congress anticipated that, in most instances, the Commission's statement of reasons for approving a proposed rule change would "simply be an endorsement of the justification filed by the self-regulatory agency."²⁴ The Commission is adopting the proposed amendments to the statement of purpose and basis, limiting the requirement to discuss problems persons are likely to have in complying with the proposed rule change. In light of objections raised by commentators,²⁵ the Commission has modified that requirement to require discussion only of significant compliance problems.

G. Item 4. Self-Regulatory Organization's Statement on Burden on Competition

Item 4 requires the self-regulatory organization to provide a discussion of any burden on competition the proposed rule change would impose. The Commission proposed to amend Item 4 to make it clear that the discussion must be clearly articulated and thorough and to specify in detail the information to be included.

¹⁸ As indicated elsewhere in this release, the Commission has decided not to adopt the proposed category for summary effectiveness of proposed rule changes subjected to pre-filing review (see text accompanying n. 46 *infra*). Therefore, the Commission is withdrawing related proposed amendments to Instructions D and E and Item 7. See the Companion Release.

¹⁹ NYSE Response, File No. S7-590.

²⁰ Section 19(b)(2) of the Act provides that the Commission shall not approve any proposed rule change before the thirtieth day after the date of publication of notice of the filing thereof, unless the Commission finds good cause for doing so. If the self-regulatory organization requests accelerated effectiveness pursuant to Section 19(b)(2), it should so indicate in Item 7(d) of Form 19b-4 and provide a statement explaining why there is good cause for the Commission to accelerate effectiveness.

²¹ NYSE Response, File No. S7-590.

²² *Id.*

²³ DTC, NASD, and NYSE Responses, File No. S7-590.

²⁴ Securities Acts Amendments of 1975, Report of the Senate Comm. on Banking, Housing and Urban Affairs to Accompany S. 249, S. Rep. No. 94-75, 94th Cong., 1st Sess. 30 (1975).

²⁵ DTC and NASD Responses, File No. S7-590.

One commentator stated that the proposed amendment would require self-regulatory organizations to speculate on competition issues.²⁶ A second commentator suggested that the requirement to discuss competition issues raised by commentators should be limited to significant issues.²⁷

The Commission believes that the statement concerning any burden on competition must be sufficiently detailed and specific to support a Commission finding that the proposed rule change does not impose any burden on competition not necessary or appropriate in furtherance of the purposes of the Act and is adopting Item 4 essentially as proposed. It has, however, revised the requirement to respond to comments received concerning any impact on competition to comments received concerning any significant impact on competition.²⁸

H. Items 5 and 9. Comments on the Proposed Rule Change

Item 5 requires the self-regulatory organization to summarize the comments it receives on a proposed rule change. The Commission proposed to amend Item 5 to require the self-regulatory organization to respond in detail to significant issues raised by commentators that are not discussed in response to Items 3 or 4.

One commentator stated that the requirement in Item 5 to respond to comments is unnecessary in light of the Item 4 requirement to provide a discussion of comments on any burden on competition.²⁹ A second commentator stated that the requirement is unnecessary because self-regulatory organizations will not risk rejection or disapproval of a proposed rule change by failing to respond to any comment concerning the statutory basis for the proposed rule change.³⁰ This commentator also stated that the new requirement would, in effect, require the self-regulatory organization to respond to every comment received because the significance of a comment would be determined not by the self-regulatory organization but by the Commission's staff in its review of the filing.³¹ A third commentator stated that the comments to which the self-regulatory organization must respond should be limited to written comments, at least as far as clearing agencies are concerned.³²

The requirement in Item 5 to respond to comments does not duplicate the Item 4 requirement to discuss comments on competition. Item 5 provides that if a comment is addressed in the statement of basis and purpose (Item 3) or discussion of competition issues (Item 4), the self-regulatory organization should cross-reference the response.

The Commission does not believe that the requirement to respond to comments raising significant issues would impose an undue burden on self-regulatory organizations. The amendment is intended to require only that the self-regulatory organization respond to written comments. The volume of such comment letters usually is not great. Frequently, none or at most a very few are received. Moreover, it has not been the Commission's experience that the comment letters typically raise inappropriate or trivial issues. Accordingly, the Commission is adopting the amendment to Item 5, modified to make clear that the requirement applies only to written comments.

A related provision, Item 9, requires the self-regulatory organization to file copies of any comment letters it receives. The Commission proposed to amend Item 9 to require the self-regulatory organization to provide, in addition to the required copies of comment letters, an alphabetical list of such letters and a transcript of comments on the proposed rule change made at any public meeting or, if a transcript is not available, a summary of such comments.

One commentator suggested that the Commission make it clear that the term "public meeting" does not include, except to the extent specifically designated as "public," meetings such as board meetings, committee meetings, and informal meetings between staff and members of the self-regulatory organization.³³ The Commission does not intend, and does not believe the term "public meeting" is generally understood, to cover such meetings. The Commission believes transcripts or summaries of comments made at public meetings would facilitate Commission review.³⁴

The Commission is adopting Item 9 as proposed with one revision. It has

revised Item 9 to reflect the requirement in Instruction D that the self-regulatory organization file copies of any correspondence or other communications reduced to writing (including comment letters) to and from the self-regulatory organization concerning the rule change that it receives or prepares after the proposed rule change is filed with the Commission but before the Commission takes final action on it.

I. Item 7. Basis for Summary Effectiveness or Accelerated Effectiveness of the Proposed Rule Change

Item 7 requires the self-regulatory organization to indicate under which provision of Section 19(b)(3), if any, it is designating the proposed rule change for summary effectiveness. The Commission is amending that item to reflect the new category for summary effectiveness of certain clearing agency rules.³⁵ It is also adding a new paragraph (d) to Item 7 providing that if the self-regulatory organization requests accelerated effectiveness pursuant to Section 19(b)(2), it must provide a statement explaining why there is good cause for the Commission to accelerate effectiveness.³⁶

J. Item 8. Proposed Rule Change Based on Other Rules

The Commission proposed a new Item 8 to require the self-regulatory organization to state whether a proposed rule change is based on a rule of another self-regulatory organization or of the Commission and, if so, to identify the rule and explain any differences between that rule and the proposed rule change.

One commentator asserted that it is inappropriate to require the self-regulatory organization to interpret the rules of another self-regulatory organization, with respect to which it does not have jurisdiction, expertise, or experience.³⁷ The Commission is adopting Item 8, revised to make clear that any discussion of rules of other self-regulatory organizations or of the Commission is to be based on the self-regulatory organization's understanding of those rules.

K. Exhibit 1. Notice of Filing

The Commission is adopting the proposed amendments to Exhibit 1 of Form 19b-4, the Notice of Filing for

²⁶ DTC Response, File No. S7-590.

²⁷ NYSE Response, File No. S7-590.

²⁸ See text accompanying n. 29 *infra*.

²⁹ NYSE Response, File No. S7-590.

³⁰ Amex Response, File No. S7-590.

³¹ *Id.*

³² DTC Response, File No. S7-590.

³³ Amex Response, File No. S7-590.

³⁴ The Commission is amending paragraph (h) of Rule 19b-4, to require that a self-regulatory organization retain in a file, available for public inspection and copying, any correspondence and other communications reduced to writing (including comment letters) to and from such self-regulatory organization concerning any proposed rule change filing, whether the correspondence or communication is prepared or received before or after the filing of the proposed rule change.

³⁵ See text accompanying n. 49 *infra*.

³⁶ See n. 20 *supra*.

³⁷ NYSE Response, File No. S7-590.

publication in the *Federal Register*.³⁸ The Commission is also adopting two other amendments to Exhibit 1. First, it is amending Item I to require that the response to the item include only the terms of substance of the proposed rule change or the text of the proposed rule change, if it is relatively brief. Second, it is amending Item II to require a brief summary of the most significant aspects, rather than the full text, of the responses to Items 3, 4, and 5 in the completed Form 19b-4. These two changes are designed to reduce the length of notices published in the *Federal Register*.

II. Expansion of Categories of Proposed Rule Changes That may Become Effective on Filing

Section 19(b)(3)(A)(iii) of the Act³⁹ authorizes the Commission to expand the categories of proposed rule changes that self-regulatory organizations may designate for summary effectiveness.⁴⁰ The Commission proposed to exercise that authority by amending Rule 19b-4 to permit the self-regulatory organization to designate a proposed rule change for summary effectiveness if the self-regulatory organization provides a thirty-day pre-filing comment period on the rule and before the rule change becomes operative affords the Commission a sixty-day period to consider abrogation (and refiling under Section 19(b)). The proposal was intended to permit proposed rule changes to be put into effect more

rapidly than frequently is the case when full Commission review and approval are required.

Commentators questioned both the usefulness of the proposed category⁴¹ and the Commission's authority to adopt it.⁴² The major objection to the proposed amendment was to the length of time required between circulation and operation of the rule.⁴³ Commentators stated that the time savings offered by the proposed category would not be sufficient to cause them to forego Commission approval under Section 19(b)(2). They suggested that the proposed new category be revised either to permit the Commission to use its discretion to set a postfiling operative date up to 60 days after filing⁴⁴ or to dispense with the post-filing delay in operation.⁴⁵

The proposed category for summary effectiveness was intended to provide, consistently with the purposes of Section 19(b), a meaningful opportunity for public comment on, and Commission review of, proposed rule changes filed under the category. The Commission believes that the suggested revisions do not make sufficient provision for comment or review before such rule changes become operative. Accordingly, because commentators indicated that they would not use the new category as proposed, the Commission is withdrawing the proposal.⁴⁶

The Commission also is not adopting the proposal suggested by certain commentators⁴⁷ that proposed rule changes of limited duration be permitted to become effective summarily. The proposal does not make adequate provision for pre-effective comment or review, nor does it provide sufficient assurance that a defective rule could be abrogated promptly. A substantive rule change involving, for example, facilities implementation or clearing practices that became operative under the proposed category might not be able to be withdrawn without undue disruption. The Commission also does not agree with commentators that the proposal would reduce the Commission's work. In fact, if adopted, the proposal might require a disproportionate amount of staff time for evaluation of such filings

to avoid disruption resulting from abrogation.⁴⁸

The Commission, however, is expanding the categories of clearing agency rules that may become effective summarily, as suggested in the Proposal Release and supported by clearing agency commentators.⁴⁹ Clearing agencies often include in their rules the precise mechanical or operational details of their procedures.⁵⁰ Frequently, minor changes in these details do not fall within any existing category of proposed rule changes that may be designated for summary effectiveness, and therefore they require Commission review and approval.

Proposed rules dealing solely with mechanical or operational details of existing clearing agency services are similar to "solely administrative" rules, which currently qualify for summary effectiveness under Section 19(b)(3)(A)(iii) of the Act. Allowing such changes to become effective on filing should increase staff time available to review other filings. The Commission believes that it is consistent with the public interest and the purposes of Section 19(b) to amend paragraph (d) of Rule 19b-4 (redesignated as paragraph (e)) by adding a new subparagraph (4) to provide that:

(e) A proposed rule change may take effect upon filing with the Commission pursuant to Section 19(b)(3)(A) of the Act if properly designated by the self-regulatory organization as *

(4) effecting a change in an existing service of a registered clearing agency that (i) does not adversely affect the safeguarding of securities or funds in the custody or control of the clearing agency or for which it is responsible and (ii) does not significantly affect the respective rights or obligations of the clearing agency or persons using the service.

The Commission believes that permitting such proposed rule changes to become summarily effective could expedite the review process significantly.⁵¹ For example, proposed

⁴⁸ The Commission has previously accelerated the effectiveness of, or taken similar steps for, temporary or test programs filed as proposed rule changes under Section 19(b)(2). The Commission will continue to do so for appropriate proposed rule changes.

⁴⁹ NSCC and OCC Responses, File No. S7-590.

⁵⁰ DTC, NSCC, and OCC Responses, File No. S7-590.

⁵¹ The Commission, at this time, is not expanding this category to include rule changes of other self-regulatory organizations. Clearing agencies, unlike other self-regulatory organizations, function primarily as providers of services to their participants. As other self-regulatory organizations develop more varied and complex services, it may become appropriate to expand the category to include certain rules of those organizations.

³⁸ For the reasons expressed in the Proposal Release, the Commission plans to continue publishing notices in the *Federal Register*. See Proposal Release, 44 FR 30932.

³⁹ Section 19(b)(3)(A) provides that a proposed rule change may take effect upon filing if designated by the self-regulatory organization as (i) constituting a stated policy, practice, or interpretation with respect to the meaning, administration, or enforcement of an existing rule of the self-regulatory organization, (ii) establishing or changing a due, fee, or other charge imposed by the self-regulatory organization, or (iii) concerned solely with the administration of the self-regulatory organization or other matters which the Commission, by rule, consistent with the public interest and the purposes of Section 19(b), may specify as without the provisions of Section 19(b)(2).

⁴⁰ The Commission announced in the Proposal Release that, as a matter of general policy, if a self-regulatory organization, other than the MSRB, files under Section 19(b)(3)(A)(ii) a proposed rule change that establishes or changes a due, fee, or other charge applicable to a non-member or a non-participant, the Commission intends, unless unusual circumstances are present, to abrogate the rule change and require that it be filed for review under Section 19(b)(2). Proposal Release, 44 FR 30928. Several commentators stated that they believe that general policy is too broad. The Commission, however, continues to believe that, in the absence of unusual circumstances, dues, fees, and other charges applicable to non-members or non-participants should receive full review under Section 19(b)(2). The general policy announced is sufficiently flexible to permit summary effectiveness on a case-by-case basis.

⁴¹ Amex, CBOE, DTC, NSCC, NYSE, and OCC Responses, File No. S7-590.

⁴² CBOE, NYSE, and OCC Responses, File No. S7-590.

⁴³ CBOE Response, File No. S7-590.

⁴⁴ NYSE Response, File No. S7-590.

⁴⁵ Amex Response, File No. S7-590.

⁴⁶ See Companion Release.

⁴⁷ CBOE, NSCC, and OCC Responses, File No. S7-590.

rule changes that make minor modifications or improvements in services or implement changes of a "housekeeping" nature would be eligible for summary effectiveness under the category.⁵²

III. Self-Regulatory Organization Actions Constituting Proposed Rule Changes

The Commission's proposals to facilitate filing and review of proposed rule changes included a new rule, proposed Rule 3b-7, defining the term "rule." That definition was intended to clarify which stated policies, practices, and interpretations and other self-regulatory actions must be filed as proposed rule changes. Commentators, however, stated that they did not believe the proposed definition would provide clarification.

The Commission has decided to withdraw proposed Rule 3b-7 and to amend Rule 19b-4 to specify more precisely which self-regulatory actions constitute proposed rule changes. The amendments to Rule 19b-4 are discussed in detail below. As background for that discussion, this section first discusses (A) the standards under the Act and under Rule 19b-4 as originally adopted for determining which actions are proposed rule changes and (B) proposed Rule 3b-7.

A. Standards Under the Act and Rule 19b-4 as Originally Adopted

Section 19(b) defines the term "proposed rule change" to mean any proposed rule or any proposed change in, addition to, or deletion from the rules of the self-regulatory organization. Read together, Sections 3(a)(27) and 3(a)(28) of the Act define "rules of a self-regulatory organization" to mean (i) the rules of the MSRB and the constitution, articles of incorporation, bylaws, and rules, or instruments corresponding thereto, of any other self-regulatory organization, and (ii) such stated policies, practices, and interpretations of the self-regulatory organization, other than the MSRB, as the Commission deems to be rules.

Paragraph (b) of Rule 19b-4 as originally adopted defines "stated policies, practices, and interpretations" to include certain self-regulatory actions and paragraph (a) of the rule deems certain of these to be rules. The definition of "stated policies, practices, and interpretations" in paragraph (b) focuses primarily on whether the self-

regulatory action is either a material aspect of the operation of the facilities of a self-regulatory organization or a statement that is made generally available to specified persons and has certain effects on those persons.⁵³ Paragraph (a) deems a stated policy, practice, or interpretation to be a rule only if it meets one of several primarily procedural tests, such as being required, under the rules of the self-regulatory organization, to be approved by the organization's governing body.⁵⁴ The standards established by paragraphs (a) and (b) were intended to ensure that all significant regulatory actions by self-regulatory organizations would be subject to Commission review.

The definition of "stated policies, practices, and interpretations" in paragraph (b) of Rule 19b-4 is sufficiently broad to encompass most significant self-regulatory initiatives. The definition, however, does not make clear that certain significant regulatory matters that may be considered to concern "privileges," rather than "rights or obligations," are within the definition. In addition, the definition does not cover significant interpretations if they are not made generally available, even if the interpretation is approved or ratified by the governing body of the self-regulatory organization.

The Commission believes that paragraph (a), which deems certain

⁵³ Paragraph (b) of Rule 19b-4 as originally adopted provided that the term "stated policies, practices, and interpretation" includes:

Any material aspect of the operation of the facilities of the self-regulatory organization or any statement made generally available to the membership of, or all participants in, or persons having or seeking access (including, in the case of national securities exchanges or registered securities associations, through a member) to facilities of, a self-regulatory organization, or to a group or category of such persons, establishing or changing any standards or guidelines with respect to (1) the rights or obligations of such persons or, in the case of national securities exchanges or registered securities associations, persons associated with such persons or (2) the application or interpretation of an existing rule.

⁵⁴ Paragraph (a) of Rule 19b-4 as originally adopted provided that a stated policy, practice, or interpretation of a self-regulatory organization shall be deemed to be a rule of the self-regulatory organization if:

(1) Action thereon by the members or by the board of directors, or similar governing body, of such self-regulatory organization is required under its constitution, articles of incorporation, by-laws, rules, or instruments corresponding thereto, (2) a self-regulatory organization elects or is required, pursuant to its constitution, articles of incorporation, by-laws, rules, or instruments corresponding thereto, to treat it as a rule change hereunder, (3) it represents a change in, addition to, or deletion from a stated policy, practice or interpretation which the self-regulatory organization previously treated as a proposed rule change or (4) it requires a determination, or affects a prior determination, pursuant to Rules 8c-1(g) or 15c2-1(g).

stated policies, practices, and interpretations to be rules, focuses too extensively on procedural aspects of how the statement was adopted rather than on the substance of the statement. For example, paragraph (a) deems a stated policy, practice, or interpretation to be a rule if it is required to be approved by the governing body of the self-regulatory organization; however, not all matters that are required to be so approved are necessarily significant enough to warrant Commission review. At the same time, certain other matters that are not required to be approved by the governing body have significant regulatory effects and should be subject to Commission review.

B. Proposed Rule 3b-7

Proposed Rule 3b-7 was intended to resolve problems encountered with Rule 19b-4 by defining the term "rule" functionally, instead of procedurally, to include statements and stated policies, practices, and interpretations having specified significant regulatory effects.⁵⁵ The definition of "rule" in proposed Rule 3b-7 was drawn, in large part, from the definition of "rule" in the Administrative Procedure Act ("APA").⁵⁶ The definition expressly excluded certain stated policies, practices, and interpretations of the self-regulatory organization that are reasonably and fairly implied by the organization's existing rules.

Commentators raised a number of objections to the proposed definition of "rule." Several commentators stated that they believe the meaning of the term "rule" is already sufficiently clear. They questioned both the Commission's authority to define "rule"⁵⁷ and the usefulness of doing so.⁵⁸ One commentator stated that the proposed definition of "rule" is difficult to read

⁵⁵ Proposed Rule 3b-7 defined "rule" to include: The whole or part of any statement or of any stated policy, practice, or interpretation (including any form, report, or questionnaire)

(a) that is of general or particular applicability and future effect,

(b) that is designed to implement, interpret, describe, or prescribe a requirement, procedure, definition, standard, guideline, policy, or any part of a corporate or financial structure or organization, and

(c) that directly or indirectly affects the rights or obligations of any person or the conduct of business by any person;

Provided, however, that the term "rule" shall not include any stated policy, practice, or interpretation with respect to an existing rule that is reasonably and fairly implied by that rule and that is not required under the rules of the self-regulatory organization to be approved by the governing body of the self-regulatory organization.

⁵⁶ 5 U.S.C. 551(4).

⁵⁷ Amex and CBOE Responses, File No. S7-590.

⁵⁸ Amex Response, File No. S7-590.

⁵² The Commission, of course, retains the authority, under Section 19(b)(3)(C), to abrogate summarily within sixty days of the date of filing any proposed rule change that has become effective under Section 19(b)(3)(A).

and understand.⁵⁹ Several commentators questioned whether the APA definition of "rule" is an appropriate basis for a definition of "rule" for self-regulatory organizations.⁶⁰ In addition, one commentator stated that the proposed definition appears to preclude the self-regulatory organization from designating actions that are not within the proposed definition as proposed rule changes.⁶¹

The major objection to proposed Rule 3b-7, however, was to the breadth of the definition of "rule."⁶² Commentators were concerned that the definition is too open-ended and would, inappropriately, cover internal administrative matters⁶³ and many day-to-day business decisions of self-regulatory organizations.⁶⁴ Clearing agencies expressed concern that the definition would cover minor changes in clearance and settlement systems.⁶⁵ A few commentators suggested that the definition would cover such statements or documents as contracts for goods and services, individual employment arrangements, real estate leases, and annual reports.⁶⁶

Several commentators focused separately on the exclusion from the definition of "rule" of any stated policy, practice, or interpretation that is "reasonably and fairly implied" by an existing rule of the self-regulatory organization and is not required under the rules of the organization to be approved by its governing body (the "exclusion"). Commentators stated that the "reasonably and fairly implied" standard would not provide sufficient guidance to self-regulatory organizations as to when an action would not be required to be filed as a proposed rule change,⁶⁷ and that the standard would allow self-regulatory determinations to be "second-guessed" by the Commission.⁶⁸ In addition, the MSRB expressed concern that, because the exclusion would not be available if the action was required to be approved by the self-regulatory organization's governing body, the exclusion would not be available for MSRB interpretations.⁶⁹ The MSRB explained that it has adopted

internal procedures to ensure that the Board itself is directly involved in the interpretive process.

C. Amendments to Rule 19b-4

The Commission continues to believe it is important to make clear to self-regulatory organizations that they must file all significant regulatory actions for Commission review.⁷⁰ The Commission also continues to believe that additional guidance can be provided, beyond that contained in Rule 19b-4 as originally adopted, as to which self-regulatory actions are proposed rule changes. In light of the comments received on proposed Rule 3b-7, however, the Commission does not believe that it is useful to attempt to provide additional guidance through a definition of "rule" based on the APA. Accordingly, the Commission is withdrawing proposed Rule 3b-7⁷¹ and is amending Rule 19b-4 to specify more precisely which self-regulatory actions are proposed rule changes.

The amendments (i) make minor modifications in the definition of "stated policies, practices, and interpretations" in paragraph (b); (ii) revise paragraph (a) (redesignated as paragraph (c)) to deem stated policies, practices, and interpretations to be proposed rule changes primarily on the basis of their substantive effect; and (iii) add a new paragraph (d) deeming to be a proposed rule change any interpretation of an existing rule of the self-regulatory organization if it is approved or ratified by the governing body of the self-regulatory organization and is not reasonably and fairly implied by the existing rule.⁷²

Paragraphs (a) through (d) of Rule 19b-4 will read as follows:

(a) Filings with respect to proposed rule changes by a self-regulatory organization shall be made on Form 19b-4.

(b) The term "stated policy, practice, or interpretation" means (1) any material aspect of the operation of the facilities of the self-regulatory organization or (2) any statement made generally available to the membership of, to all participants in, or to persons having or seeking access (including, in the case of national securities exchanges or registered

securities associations, through a member) to facilities of, the self-regulatory organization ("specified persons"), or to a group or category of specified persons, that establishes or changes any standard, limit, or guideline with respect to (i) the rights, obligations, or privileges of specified persons or, in the case of national securities exchanges or registered securities associations, persons associated with specified persons, or (ii) the meaning, administration, or enforcement of an existing rule.

(c) A stated policy, practice, or interpretation of the self-regulatory organization shall be deemed to be a proposed rule change unless (1) it is reasonably and fairly implied by an existing rule of the self-regulatory organization or (2) it is concerned solely with the administration of the self-regulatory organization and is not a stated policy, practice, or interpretation with respect to the meaning, administration, or enforcement of an existing rule of the self-regulatory organization.

(d) Regardless of whether it is made generally available, an interpretation of an existing rule of the self-regulatory organization shall be deemed to be a proposed rule change if (1) it is approved or ratified by the governing body of the self-regulatory organization and (2) it is not reasonably and fairly implied by that rule.

Paragraphs (b), (c), and (d) will operate as discussed below.

1. Paragraph (b): Definition of Stated Policy, Practice, or Interpretation

Revised paragraph (b) continues to define "stated policy, practice, or interpretation" as, essentially, (1) any material aspect of the operation of the facilities of the self-regulatory organization or (2) any statement that the self-regulatory organization makes generally available to specified persons and that has certain effects.⁷³ The revised definition differs from the definition as originally adopted in several minor respects.

First, the revised definition substitutes "stated policy, practice, or interpretation means" for "stated policies, practices, and interpretations includes" to clarify that a self-regulatory action that is not within the definition is not a stated policy, practice, or interpretation.⁷⁴ Second, for simplification, it adds the term "specified persons" as a definition

⁵⁹ CBOE Response, File No. S7-590.

⁶⁰ Amex, CBOE, and NSCC Responses, File No. S7-590.

⁶¹ OCC Response, File No. S7-590. See n. 74 *infra*.

⁶² Amex, CBOE, DTC, NSCC, NYSE, and OCC Responses, File No. S7-590.

⁶³ Amex, CBOE, and NYSE Responses, File No. S7-590.

⁶⁴ Amex, NSCC, NYSE, and OCC Responses, File No. S7-590.

⁶⁵ DTC and NSCC Responses, File No. S7-590.

⁶⁶ CBOE, DTC, NSCC, NYSE, and OCC Responses, File No. S7-590.

⁶⁷ NSCC, NYSE, and OCC Responses, File No. S7-590.

⁶⁸ OCC Response, File No. S7-590.

⁶⁹ MSRB Response, File No. S7-590.

⁷⁰ The Commission expects that, in most instances where a self-regulatory organization acts in such a manner as to have a significant regulatory impact on persons, the self-regulatory organization will designate the action as a "rule." Sections 6, 15A, 15B, and 17A of the Act provide that self-regulatory organizations must have "rules" designed to achieve specified objectives.

⁷¹ See Companion Release.

⁷² Self-regulatory organizations may seek interpretive advice from the Commission's staff in those instances where the self-regulatory organization is uncertain whether a particular action is a proposed rule change or should have been previously treated as one.

⁷³ Material, even if it is not included in the definition of "stated policy, practice, or interpretation," that the self-regulatory organization (other than a registered clearing agency) makes generally available is required to be filed with the Commission under Rules 6a-3, 15A-1, and 17a-21 under the Act, 17 CFR 240.6a-3, 240.15A-1, and 240.17a-21. Rule 17a-22, the adoption of which is announced in this release, will impose a similar requirement on registered clearing agencies.

⁷⁴ The self-regulatory organization could, of course, elect to designate as a "rule" a statement that is not within the definition of "stated policy, practice, or interpretation."

of the persons included in the definition of "stated policy, practice, or interpretation" in Rule 19b-4.

Third, the revised definition adds the word "limit" to the list of specified effects to make clear that a statement prohibiting conduct is within the definition. Fourth, it adds in paragraph (b)(2)(i) the word "privileges" to make clear that statements establishing or changing any standard, limit, or guideline with respect to the privileges of specified persons are within the definition. Finally, it substitutes, in paragraph (b)(2)(ii), "meaning, administration, or enforcement of an existing rule" for "application or interpretation of an existing rule." That substitution is intended to conform the language of the provision to that in Section 19(b)(3)(A)(i) of the Act and is not intended to change the meaning of paragraph (b)(2).⁷⁵

2. Paragraph (c): Stated Policy, Practice, or Interpretation Deemed to be a Proposed Rule Change

Revised paragraph (c) is intended to limit the stated policies, practices, and interpretations subject to Commission review to those most likely to affect significantly the activities of specified persons. It does so by excepting two categories of stated policies, practices, and interpretations from those deemed to be proposed rule changes. The first exception is for stated policies, practices, and interpretations "reasonably and fairly implied" by the self-regulatory organization's existing rules. The second exception is for certain stated policies, practices, and interpretations that are "concerned solely with the administration" of the self-regulatory organization. The two exceptions are intended to operate independently of each other; if the action meets the requirements of either exception, it will not be considered a proposed rule change under paragraph (c). The two exceptions are discussed further below.

(i) "Reasonably and Fairly Implied" Exception

The "reasonably and fairly implied" exception is intended to make clear that self-regulatory organizations may issue stated policies, practices, and interpretations with respect to their existing rules without necessarily being subject to rule filing requirements. For

example, interpretations of existing rules arising out of individual enforcement or disciplinary proceedings would not have to be filed as proposed rule changes if the interpretations are reasonably and fairly implied by the existing rules.

The "reasonably and fairly implied" standard is the same standard used in proposed Rule 3b-7 to except certain stated policies, practices, and interpretations from the definition of "rule." The Commission believes, in spite of commentators' objections that the standard is vague, that it provides as much guidance to self-regulatory organizations as is now possible. The limits of the "reasonably and fairly implied" exception will have to be determined on a case-by-case basis. It is clear, however, that a stated policy, practice, or interpretation that prescribes extensive and specific limitations on particular types of transactions or conduct that are not apparent from the face of the existing rule is not "reasonably and fairly implied" by the rule.⁷⁶ Moreover, the fact that a self-regulatory organization, for purposes of its internal operations, characterizes a stated policy, practice, or interpretation as reasonably and fairly implied does not mean the statement is reasonably and fairly implied for purposes of Rule 19b-4.⁷⁷

(ii) "Concerned Solely with the Administration" Exception

The "concerned solely with the administration" exception in paragraph (c) is intended to prevent the self-regulatory organization from having to file as a proposed rule change most stated policies, practices, or interpretations that deal solely with

⁷⁶ As the Commission explained in connection with its discussion of the "reasonably and fairly implied" standard in the exclusion of proposed Rule 3b-7, the standard would not be met by an interpretation such as that filed by the CBOE and other exchanges concerning "front-running." See, e.g., File No. SR-CBOE-78-28. The standard also would not be met by a stated policy, practice, or interpretation that implements a system if it affects the manner in which members or others do business or in which the system functions, in a way that is not reasonably foreseeable from the rule to which the stated policy, practice, or interpretation applies.

⁷⁷ For example, the governing body of the NASD adopts or amends specific implementing policies under general rules adopted by its membership, such as its rule requiring observance of just and equitable principles of trade, and, for purposes of its by-laws, characterizes the implementing policies as reasonably and fairly implied by the general rules. See the NASD's interpretations and policy statements relating to "free-riding," advertising, and underwriting arrangements. Such interpretations or policy statements are required to be filed as proposed rule changes. NASD Manual (CCH) ¶2151. See also Article VII of the NASD's By-Laws, NASD Manual (CCH) ¶1501 *et seq.*

"housekeeping" matters.⁷⁸ The exception should eliminate concern, stemming from the definition of "rule" in proposed Rule 3b-7, that self-regulatory organizations would have to file as proposed rule changes stated policies, practices, or interpretations relating to matters such as floor decorum.⁷⁹

The exception would not be available for stated policies, practices, and interpretations with respect to the meaning, administration, or enforcement of an existing rule of the self-regulatory organization. The Commission believes that, once the self-regulatory organization has chosen to handle a housekeeping matter by rule, the Commission and the public should be given notice of any stated policy, practice, or interpretation that effectively modifies the terms of that rule.⁸⁰ Any such stated policy, practice, or interpretation should be set forth in the self-regulatory organization's rule book.

3. Paragraph (d): Governing Body Interpretations Deemed to be Proposed Rule Changes

The Commission believes that any interpretation of an existing rule that is of sufficient importance to be approved or ratified by the governing body of the self-regulatory organization, whether or not it is made generally available, is a proposed rule change subject to Commission review unless it is reasonably and fairly implied by the existing rule.

Accordingly, the Commission is amending Rule 19b-4 to provide, in paragraph (d), that regardless of whether it is made generally available, an interpretation of an existing rule of the self-regulatory organization is a proposed rule change if it is approved or ratified by the governing body of the self-regulatory organization and it is not reasonably and fairly implied by the

⁷⁸ If the self-regulatory organization adopts a "rule" that is concerned solely with the administration of the organization, that rule is required to be filed as a proposed rule change, but it may qualify for summary effectiveness under Section 19(b)(3)(A) of the Act.

⁷⁹ An administrative stated policy, practice, or interpretation having implications beyond housekeeping matters would not, of course, qualify for this exception. For example, a stated policy, practice, or interpretation establishing or changing floor procedures, procedures for resolving or determining the rights or obligations of members, or composition of the self-regulatory organization's governing body would generally not be "concerned solely with the administration" of the self-regulatory organization.

⁸⁰ For example, if the self-regulatory organization has a rule establishing a dress code, any stated policy, practice, or interpretation with respect to the dress code would be a proposed rule change, unless it is reasonably and fairly implied by the rule, in which case it would qualify for the first exception.

⁷⁵ A form, report, or questionnaire of a self-regulatory organization that constitutes a stated policy, practice, or interpretation under paragraph (b) would have to be filed as a proposed rule change if, under paragraph (c), it is a stated policy, practice, or interpretation deemed to be a proposed rule change.

existing rule.⁸¹ Paragraph (d) makes clear that, whenever the governing body of the self-regulatory organization, including that of the MSRB,⁸² approves or ratifies an interpretation that is not reasonably and fairly implied by an existing rule, its action is a proposed rule change.

IV. Revocation of Certain Filing Requirements; Adoption of Rule 17a-22 Concerning Registered Clearing Agencies

The Commission proposed to revoke several filing requirements that it believes are unduly burdensome. First, the Commission proposed to revoke the provision in paragraph (c) of Rule 19b-4 as originally adopted, and related Form 19b-4B, requiring self-regulatory organizations to file on Form 19b-4B notice of stated policies, practices, and interpretations not deemed to be rules. The filing requirement partially duplicates filing requirements in Rules 6a-3, 15A-1, and 17a-21 under the Act,⁸³ which require national securities exchanges, registered securities associations, and the MSRB, respectively, to submit to the Commission any material they make generally available.

Second, the Commission proposed to revoke Rule 17a-18, which requires a national securities exchange or registered securities association to file with the Commission any form, report, or questionnaire it requires or proposes to require its members to complete. The Commission believes this requirement is unnecessary because self-regulatory organizations are required to file such documents under Section 19(b).

Finally, the Commission proposed to revoke paragraph (g) of Rule 19b-4. Paragraph (g) required self-regulatory organizations to respond to Items 3, 4, 5, and 6 of Form 19b-4A with respect to their rules in effect on June 4, 1975, and to file those responses with the Commission by April 1, 1976. Paragraph (g) was intended to afford national securities exchanges and associations an opportunity to provide relevant information on their existing rules before any Commission action under

Section 31(b) of the Securities Acts Amendments of 1975. Commentators expressed the view that the information supplied would be of little assistance to the Commission and that supplying the information would impose a considerable burden on self-regulatory organizations. To avoid imposing that burden, the Commission decided in early 1976 not to require compliance with paragraph (g) of Rule 19b-4.⁸⁴

The Commission did not receive any comments on its proposals to revoke the Form 19b-4B filing requirement, Rule 17a-18, and paragraph (g) of Rule 19b-4, and, as proposed, is revoking those provisions.

In conjunction with its proposal to revoke Form 19b-4B, the Commission proposed Rule 17a-22, which would establish for registered clearing agencies a filing requirement parallel to the filing requirements imposed under Rules 6a-3, 15A-1, and 17a-21. Registered clearing agencies, unlike national securities exchanges, registered securities associations, and the MSRB, previously have not been required to file with the Commission materials (other than stated policies, practices, and interpretations deemed not to be rules) they make generally available. Receipt of such material is important to the Commission's oversight responsibilities under the Act. The Commission did not receive any comments on proposed Rule 17a-22 and is adopting the rule as proposed, with minor modifications.

V. Statutory Basis

On the basis of the foregoing analysis and discussion, the Commission finds that the rule and the amendments to the rule and the form adopted are consistent with the public interest, the protection of investors, and the purposes of the Act. The Commission also finds that the amendment to paragraph (e) of Rule 19b-4, expanding the categories of proposed rule changes that may become effective pursuant to Section 19(b)(3)(A) of the Act, is consistent with the public interest and the purposes of Section 19(b) of the Act. The Commission, pursuant to Section 23(a)(2) of the Act, finds that the rule and the amendments to the rule and the form adopted herein do not impose any burdens on competition.

Rule 17a-22 is promulgated under the Act, and particularly Sections 2, 3, 17, 17A, and 23, 15 U.S.C. 78b, 78c, 78q, 78q-1, and 78w. The amendments to Rule 19b-4 and Form 19b-4A (redesignated as Form 19b-4) are promulgated under

the Act, and particularly Sections 2, 3, 6, 11A, 15A, 15B, 17, 17A, 19, and 23, 15 U.S.C. 78b, 78c, 78f, 78k-1, 78o-3, 78o-4, 78q, 78q-1, 78s, and 78w.

VI. Text of Rules and Form

The Commission is amending Title 17, Chapter II, of the Code of Federal Regulations as follows:

PART 240—GENERAL RULES AND REGULATIONS, SECURITIES EXCHANGE ACT OF 1934

§ 240.17a-18 [Removed]

1. By revoking § 240.17a-18.
2. By adding § 240.17a-22 to read as follows:

§ 240.17a-22 Supplemental material of registered clearing agencies.

Within ten days after issuing, or making generally available, to its participants or to other entities with whom it has a significant relationship, such as pledgees, transfer agents, or self-regulatory organizations, any material (including, for example, manuals, notices, circulars, bulletins, lists, or periodicals), a registered clearing agency shall file three copies of such material with the Commission. A registered clearing agency for which the Commission is not the appropriate regulatory agency shall at the same time file one copy of such material with its appropriate regulatory agency.

(Secs. 2, 3, 17, and 23, Pub. L. No. 78-291, 48 Stat. 881, 882, 897, and 901, as amended by secs. 2, 3, 14, and 18, Pub. L. No. 94-29, 89 Stat. 97, 137, and 155 (15 U.S.C. 78b, 78c, 78q, and 78w); sec. 17A, as added by sec. 15, Pub. L. No. 94-29, 89 Stat. 141 (15 U.S.C. 78q-1))

3. By revising § 240.19b-4 to read as follows:

§ 240.19b-4 Filings with respect to proposed rule changes by self-regulatory organizations.

(a) Filings with respect to proposed rule changes by a self-regulatory organization shall be made on Form 19b-4.

(b) The term "stated policy, practice, or interpretation" means (1) any material aspect of the operation of the facilities of the self-regulatory organization or (2) any statement made generally available to the membership of, to all participants in, or to persons having or seeking access (including, in the case of national securities exchanges or registered securities associations, through a member) to facilities of, the self-regulatory organization ("specified persons"), or to a group or category of specified persons, that establishes or changes any standard, limit, or guideline with respect to (i) the rights, obligations, or privileges

⁸¹ If the governing board of the self-regulatory organization establishes a committee to approve or ratify interpretations, the self-regulatory organization should treat interpretations approved or ratified by that committee as having been acted upon by the governing body.

⁸² Paragraph (d) makes clear that if the MSRB issues an interpretation of an existing rule that is not reasonably and fairly implied by that rule, it is a proposed rule change.

⁸³ 17 CFR 240.6a-3, 240.15A-1, and 240.17a-21. Rule 17a-22, the adoption of which is announced in this release, will impose a similar requirement on registered clearing agencies.

⁸⁴ Securities Exchange Act Release Nos. 12157 (Mar. 2, 1976), 41 FR 10662 (Mar. 12, 1976), and 13100 (Dec. 22, 1976), 42 FR 782 (Jan. 4, 1977).

of specified persons or, in the case of national securities exchanges or registered securities associations, persons associated with specified persons, or (ii) the meaning, administration, or enforcement of an existing rule.

(c) A stated policy, practice, or interpretation of the self-regulatory organization shall be deemed to be a proposed rule change unless (1) it is reasonably and fairly implied by an existing rule of the self-regulatory organization or (2) it is concerned solely with the administration of the self-regulatory organization and is not a stated policy, practice, or interpretation with respect to the meaning, administration, or enforcement of an existing rule of the self-regulatory organization.

(d) Regardless of whether it is made generally available, an interpretation of an existing rule of the self-regulatory organization shall be deemed to be a proposed rule change if (1) it is approved or ratified by the governing body of the self-regulatory organization and (2) it is not reasonably and fairly implied by that rule.

(e) A proposed rule change may take effect upon filing with the Commission pursuant to Section 19(b)(3)(A) of the Act if properly designated by the self-regulatory organization as (1) constituting a stated policy, practice, or interpretation with respect to the meaning, administration, or enforcement of an existing rule, (2) establishing or changing a due, fee, or other charge, (3) concerned solely with the administration of the self-regulatory organization, or (4) effecting a change in an existing service of a registered clearing agency that (i) does not adversely affect the safeguarding of securities or funds in the custody or control of the clearing agency or for which it is responsible and (ii) does not significantly affect the respective rights or obligations of the clearing agency or persons using the service.

(f) After instituting a proceeding to determine whether a proposed rule change should be disapproved, the Commission will afford the self-regulatory organization and interested persons an opportunity to submit additional written data, views, and arguments and may afford, in the discretion of the Commission, an opportunity to make oral presentations.

(g) Notice of orders issued pursuant to Section 19(b) of the Act will be given by prompt publication thereof, together with a statement of written reasons therefor.

(h) Self-regulatory organizations shall retain at their principal place of

business a file, available to interested persons for public inspection and copying, of all filings made pursuant to this section and all correspondence and other communications reduced to writing (including comment letters) to and from such self-regulatory organization concerning any such filing, whether such correspondence and communications are received or prepared before or after the filing of the proposed rule change.

(Secs. 2, 3, 6, 17, 19, and 22, Pub. L. No. 78-291, 48 Stat. 881, 882, 885, 897, 898, and 901, as amended by secs. 2, 3, 4, 14, 16, and 18, Pub. L. No. 94-29, 89 Stat. 97, 104, 137, 146, and 155 (15 U.S.C. 78b, 78c, 78f, 78g, 78s, and 78w); sec. 15A, as added by sec. 1, Pub. L. No. 75-719, 52 Stat. 1070, as amended by sec. 12, Pub. L. No. 94-29, 89 Stat. 127 (15 U.S.C. 78o-3); secs. 11A, 15B, and 17A, as added by secs. 7, 13, and 15, Pub. L. No. 94-29, 89 Stat. 111, 131, and 141 (15 U.S.C. 78k-1, 78o-4, and 78q-1))

PART 249—FORMS, SECURITIES EXCHANGE ACT OF 1934

§ 249.819a [Redesignated as § 249.819 and Amended]

1. By redesignating § 249.819a (Form 19b-4A, for filings with respect to proposed rule changes by all self-regulatory organizations) as § 249.819, by amending the heading of this section to refer to "Form 19b-4," and by amending the text of this form as provided by this release.

§ 249.819b [Removed]

2. By revoking § 249.819b.
Copies of the form have been filed with the Office of the Federal Register and will be forwarded to the self-regulatory organizations. Copies may be requested from the Commission.

By the Commission.

George A. Fitzsimmons,
Secretary.

October 30, 1980.

[FR Doc. 80-34737 Filed 11-6-80; 8:45 am]

BILLING CODE 8010-01-M

17 CFR Part 270

[Release No. IC-11421]

Prevention of Certain Unlawful Activities With Respect to Registered Investment Companies

AGENCY: Securities and Exchange Commission.

ACTION: Final rule.

SUMMARY: The Securities and Exchange Commission announced that it is adopting a rule under the Investment Company Act of 1940 to provide guidance to investment companies as to the minimum standards of conduct

appropriate for persons who have access to information regarding the purchase and sale of portfolio securities by investment companies. The rule prohibits certain activities on the part of persons affiliated with registered investment companies or their investment advisers or principal underwriters. In addition, the rule requires such entities to establish codes of ethics applicable to certain persons associated with them, and requires that these persons make certain reports regarding their securities transactions.

EFFECTIVE DATE: (1) As to paragraph (a), October 31, 1980; (2) as to all other paragraphs, May 1, 1981.

FOR FURTHER INFORMATION CONTACT: S. Elliott Cohan, Esq. (202) 272-2060, Division of Investment Management, Securities and Exchange Commission, Washington, D.C. 20549.

SUPPLEMENTARY INFORMATION: The Securities and Exchange Commission ("Commission") is adopting Rule 17j-1 [17 CFR 270.17j-1] ("Rule") under the Investment Company Act of 1940 ("Act"). The Rule is designed to implement Section 17(j) of the Act [15 U.S.C. 80a-17(j)] which provides that:

It shall be unlawful for any affiliated person of or principal underwriter for a registered investment company or any affiliated person of an investment adviser of or principal underwriter for a registered investment company, to engage in any act, practice, or course of business in connection with the purchase or sale, directly or indirectly, by such person of any security held or to be acquired by such registered investment company in contravention of such rules and regulations as the Commission may adopt to define, and prescribe means reasonably necessary to prevent, such acts, practices, or courses of business as are fraudulent, deceptive or manipulative. Such rules and regulations may include requirements for the adoption of codes of ethics by registered investment companies and investment advisers of, and principal underwriters for, such investment companies establishing such standards as are reasonably necessary to prevent such acts, practices, or courses of business.

Background

Section 17(j) was added to the Act in 1970 as a result of a recommendation to Congress by the Commission that the Commission be authorized to adopt rules for the protection of investors in connection with trading in securities purchased and sold by investment companies by persons affiliated with them or their investment advisers or principal underwriters.¹ This

¹ See Public Policy Implications of Investment Company Growth, H.R. Rep. No. 2337, 89th Cong., 2d Sess. 200 (1966).