SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 270

[Release No. IC–21838, File No. S7–7–96]

RIN 3235–AG61

Exemption for the Acquisition of Securities During the Existence of an Underwriting Syndicate

AGENCY: Securities and Exchange Commission.

ACTION: Proposed rule.

SUMMARY: The Commission is proposing amendments to the rule under the Investment Company Act of 1940 that permits investment companies that are affiliated with members of underwriting syndicates to purchase securities underwritten by these syndicates if certain conditions are met. The proposed amendments are designed to make the rule more flexible by, among other things, increasing the percentage of an underwriting that an investment company may purchase in reliance on the rule and expanding the scope of the rule to include foreign securities. The proposed amendments, and a proposed new companion rule, also would permit investment companies to acquire municipal securities from underwriting syndicates in ''group sales.'' The proposed amendments respond to changes in the investment company and underwriting industries that have occurred since the rule last was substantively amended in 1979.

DATES: Comments must be received on or before June 3, 1996.

ADDRESSES: Comments should be submitted in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Stop 6–9, Washington, DC 20549. Comments also may be submitted electronically at the following E-mail address: rule-comments@sec.gov. All comment letters should refer to File No. S7–7–96; this file number should be included on the subject line if E-mail is used. Comment letters will be available for public inspection and copying in the Commission's Public Reference Room, 450 Fifth Street, NW., Washington, DC 20549. Electronically submitted comment letters will be posted on the Commission's Internet web site (http://www.sec.gov).

FOR FURTHER INFORMATION CONTACT: David M. Goldenberg, Senior Counsel, or Kenneth J. Berman, Assistant Director, at (202) 942–0690, Office of Regulatory Policy, Division of Investment Management, Stop 10–6, 450 Fifth Street, NW., Washington, DC 20549.

SUPPLEMENTARY INFORMATION: The Commission today is requesting public comment on proposed amendments to rule 10f–3 (17 CFR 270.10f–3) and a proposed new rule, rule 17a–10 (17 CFR 270.17a–10), under the Investment Company Act of 1940 (15 U.S.C. 80a–1 *et seq.*) (the ''Investment Company Act'').

Table of Contents

Executive Summary

Section 10(f) of the Investment Company Act was designed to address the practice prior to 1940 by some securities underwriters (''underwriters'') of ''dumping'' unmarketable securities on their affiliated investment companies (''funds''). The section prohibits a fund from purchasing securities for which an underwriter having certain relationships with the fund (''affiliated underwriter'') is acting as a principal underwriter during the existence of an underwriting or selling syndicate. Rule 10f–3 under the Investment Company Act permits funds to purchase securities during the existence of an underwriting syndicate under specified conditions designed to assure that the purchase is consistent with the protection of fund investors. These conditions include requirements that (i) the purchased securities be either registered under the Securities Act of 1933 (''Securities Act'') or municipal securities, (ii) the fund (along with other funds advised by the same investment adviser) purchase no more than the greater of four percent of the underwritten securities, or $500,000, but in no case more than 10% of the offering (the ''percentage limit''), (iii) the fund use no more than three percent of its assets to purchase securities in a transaction subject to the rule, and (iv) the fund not purchase the securities from the affiliated underwriter. The last condition also prohibits a fund from purchasing municipal securities in a ''group sale,'' which is a sale for which all members of a syndicate receive credit in proportion to their respective underwriting commitments.

The Commission believes that the conditions of rule 10f–3 should be reevaluated in light of changes in the fund and financial services industries since the principal provisions of rule 10f–3 were last amended in 1979 and is proposing amendments to the rule that reflect these changes. The proposed amendments are intended to provide funds with additional flexibility, consistent with the policies underlying section 10(f), to make investments that may be in the best interests of investors.

The proposed amendments would raise the percentage limit to the greater of 10% of an offering or $1,000,000 (but not to exceed 15% of the offering). The proposed amendments also would eliminate the current limit on the amount of a fund's assets that may be used to make purchases pursuant to the rule and the current requirement that funds report rule 10f–3 transactions in their semi-annual reports filed with the Commission on Form N–SAR.

In recognition of the increase in the extent to which funds invest in foreign securities, the proposed amendments would expand rule 10f–3 to permit funds to purchase securities of foreign issuers (''foreign securities'') that are not registered under the Securities Act, subject to certain conditions. These conditions are designed to permit funds to purchase foreign securities in transactions having certain characteristics similar to public offerings in the United States, such as disclosure of specified information and a single public offering price.

The proposed amendments would permit funds to purchase municipal securities in group sales, subject to certain conditions designed to protect against overreaching by fund affiliates. Purchases of securities in group sales would be permitted, for example, only when the underwriting syndicate has established that group sales would have priority over other types of sales.

I. Background

A. Introduction

A central theme underlying the regulation of investment companies is the concern that fund affiliates could

use fund assets for their own purposes, to the detriment of fund shareholders. One of the major abuses noted in the period preceding the Investment Company Act was the use of funds by underwriters that controlled these funds as a ''dumping ground'' for unmarketable securities.[1] An underwriter could, for example, ''dump'' unmarketable securities on its controlled fund, either by causing the fund to purchase the securities from the underwriter itself, or by encouraging the fund to purchase securities from another member of the underwriting syndicate. Fund assets also could be used to absorb the risks of an underwriting in more subtle ways, such as to facilitate price stabilization in connection with an underwriting.[2]

Section 10(f) of the Investment Company Act was designed to address these concerns.[3] The section prohibits a fund from purchasing securities for which an affiliated underwriter is acting as a principal underwriter during the existence of an underwriting or selling syndicate.[4] Recognizing that section 10(f), by prohibiting *all* purchases by funds affiliated with members of an underwriting syndicate during the existence of the syndicate, could be overly broad, Congress gave the Commission specific authority to exempt persons from that section by order or rule when the exemption is consistent with the protection of investors.[5]

B. Rule 10f–3

In 1958, the Commission used its exemptive authority under section 10(f) to adopt rule 10f–3.[6] The rule permits a fund to purchase securities in a transaction that otherwise would violate section 10(f) if, among other things (i) the securities are either registered under the Securities Act or municipal securities, (ii) the offering involves a ''firm commitment'' underwriting,[7] (iii) the fund and all other funds advised by the same investment adviser do not in the aggregate purchase more than the greater of 4% of the principal amount of the securities being offered or $500,000 (but in no event greater than 10% of the offering), (iv) the fund does not use more than 3% of its assets to purchase the securities, (v) the fund purchases the securities from a member of the syndicate other than the affiliated underwriter, (vi) the fund purchases the securities at a price not more than the public offering price prior to the end of the first full business day after the first date on which the securities are offered, and (vii) the fund's directors have adopted procedures for purchases made in reliance on the rule and regularly review fund purchases to determine whether they comply with these procedures.[8] The conditions of rule 10f–3 are designed to ensure that a purchase by a fund from a syndicate in which an affiliated underwriter is participating is consistent with the protection of fund investors.

C. Need for Amendments

The Commission believes that the conditions of rule 10f–3 should be reevaluated in light of changes in the financial markets, particularly in the fund and financial services industries.[9]

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[1] *See Investment Trusts and Investment Companies: Hearings on S. 3580 Before a Subcomm. of the Senate Comm. on Banking and Currency,* 76th Cong., 3d Sess. 35 (1940) (statement of Commissioner Healy).

[2] In its study of the fund industry prior to 1940, the Commission gave specific examples of cases in which underwriters had used the assets of their affiliated funds to benefit the underwriters or to save them from insolvency. *See generally* SEC, Investment Trusts and Investment Companies, H.R. Doc. No. 279, 76th Cong., 1st Sess., pt. 3, at 2519–2624 (1939). The Commission explained:

The control of an investment company by an investment banker naturally impresses the client, who desires to be financed, with the resources that the investment banker may call upon to make the financing operation successful, such as, selling some of the securities to the investment company, securing the company's participation in the underwriting commitment, including the company in trading accounts or using the company's funds in stabilizing the market.

Id. at 2535–36.

[3] See 2 T. Frankel, The Regulation of Money Managers 555 (1978) (''The purpose of [section 10(f)] is to protect investment companies from purchasing securities to advance the interests of their affiliates rather than their own.''). Even in the absence of section 10(f), a fund effectively would be prohibited by section 17(a) of the Investment Company Act from purchasing securities directly from its affiliated underwriter or from an affiliate of its affiliate. *See* 15 U.S.C. 80a–17(a). That section 10(f) prevents a fund from acquiring securities from an unaffiliated member of the underwriting syndicate would seem to reflect the view that the affiliated underwriter has the potential to pressure the fund into acquiring the securities through another underwriter in order to facilitate the underwriting. If each member of a syndicate has proportionate liability for securities remaining unsold, as is frequently the case in many municipal securities syndicates, for example, the successful sale of all of the securities, regardless of from which member of the syndicate the securities are purchased, benefits all members of the syndicate, including the affiliated underwriter.

[4] ''Principal Underwriter'' is defined in section 2(a)(29) of the Investment Company Act, 15 U.S.C. 80a–2(a)(29), to mean (in relevant part) an underwriter who, in connection with a primary distribution of securities, (A) is in privity of contract with the issuer or an affiliated person of the issuer, (B) acting alone or in concert with one or more other persons, initiates or directs the formation of an underwriting syndicate, or (C) is allowed a rate of gross commission, spread, or other profit greater than the rate allowed another underwriter participating in the distribution.

[5] Section 10(f) prohibits a fund from purchasing a security during the existence of an underwriting or selling syndicate if a principal underwriter of the security is an officer, director, member of an advisory board, investment adviser, or employee of the fund, or is a person of which any such officer, director, member of an advisory board, investment adviser, or employee is an affiliated person. For purposes of this release, a person that falls within one of these categories is referred to as an ''affiliated underwriter,'' and the syndicate of which such person is a member is referred to as an ''affiliated underwriting syndicate.'' Funds that are subject to section 10(f) because an affiliated underwriter is a member of a syndicate are referred to as ''affiliated funds.''

[6] *See* Adoption of Rule N–10F–3 Permitting Acquisition of Securities of Underwriting Syndicate Pursuant to Section 10(f) of the Investment Company Act of 1940, Investment Company Act Release No. 2797 (Dec. 2, 1958), 23 FR 9548 (hereinafter ''1958 Adopting Release''). The rule codified the conditions of orders that the Commission had granted prior to 1958 exempting certain funds from section 10(f) to permit them to purchase specific securities. *See, e.g.,* The Chicago Corporation, Release No. 40–107 (Apr. 8, 1941); The Pennroad Corporation, Investment Company Act Release No. 1636 (Aug. 10, 1951).

The Commission amended rule 10f–3 in 1979 to permit its use for the purchase of municipal securities, in 1985 to reflect changes in the periodic reporting requirements for all funds, and again in 1993 to remove a requirement that fund boards annually review procedures adopted pursuant to the rule. *See* Exemption of Acquisition of Securities During the Existence of Underwriting Syndicate, Investment Company Act Release No. 10736 (June 14, 1979), 44 FR 36152 (hereinafter ''1979 Adopting Release''); Withdrawal of Quarterly Reporting Forms and Filing Obligation of Certain Registered Investment Companies, Securities Act Release No. 6591 (July 1, 1985), 50 FR 29368; Revision of Certain Annual Review Requirements of Investment Company Boards of Directors, Securities Act Release No. 7013 (Sept. 17, 1993), 58 FR 49919.

[7] A ''firm commitment'' underwriting, for purposes of rule 10f–3, is one in which the underwriters are committed to purchase all of the securities being offered, if the underwriters purchase any of the securities being offered. *See* rule 10f–3(a)(3).

[8] The provisions of rule 10f–3 are similar to provisions permitting limited affiliated transactions by persons subject to section 406 of the Employee Retirement Income Security Act of 1974 (''ERISA''), 29 U.S.C. 1106, and by banks subject to section 23B of the Federal Reserve Act, 12 U.S.C. 371c–1. Section 406 of ERISA, as interpreted by the Department of Labor, prohibits a plan fiduciary from purchasing a security for the plan from a syndicate in which an affiliate of the fiduciary is an underwriter. *See* Prohibited Transaction Class Exemption 75–1 (Oct. 24, 1975) (''PTCE 75–1''). The Department of Labor has issued a class exemption permitting purchases in limited circumstances, subject to conditions similar to rule 10f–3. *Id.*

Section 23B of the Federal Reserve Act, 12 U.S.C. 371c–1(b), like section 10(f) of the Investment Company Act, prohibits a bank or its subsidiary from purchasing, as principal or fiduciary, securities from underwriting syndicates in which an affiliate of the bank participates. Section 23B, however, permits acquisitions of these securities if a majority of the bank's independent directors have approved the acquisition in advance. 12 U.S.C. 371c–1(b)(2).

[9] The Commission first recognized a need to reevaluate rule 10f–3 when it issued a release in 1986 requesting comment on whether the Commission should amend the rule, and requesting suggestions on possible amendments. *See* Advance Notice and Request for Comment on Whether the Commission Should Amend an Existing Rule that

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The number of funds and the amount of assets invested in funds has grown exponentially since 1980.[10] The increase in the number and size of funds has resulted in funds becoming major sources of capital and significant purchasers in syndicated offerings.[11] This growth, however, has had an effect on the ability of funds to use rule 10f–3. The provisions in the rule limiting the amount of an offering that a fund may purchase may, in effect, be more restrictive today than they were when the Commission last substantively amended the rule in 1979.[12]

The growth of the fund industry has been accompanied by changes in the financial services industry that have limited the usefulness of rule 10f–3. Over the recent past, the financial services industry has become more concentrated as large financial conglomerates have replaced smaller, independent underwriting firms.[13] Increasing concentration in the underwriting industry has made it more likely that an affiliated underwriter will participate in an underwriting syndicate. In addition, more underwriters have either developed or otherwise become affiliated with fund complexes, and the sponsors of some fund complexes have established broker-dealer affiliates.[14] As a result of the increasing affiliations among funds and underwriters, more funds have become, and more are likely in the future to become, subject to section 10(f).

Another significant change in the fund industry since 1980 has been the dramatic increase in the number of funds that invest in foreign securities.[15] This trend may be the result of a combination of several factors, including the internationalization of the securities markets and increased investor interest in overseas investment opportunities.[16] The increase in demand for foreign securities by U.S. funds has been accompanied by an increase in the participation of U.S. underwriters in the global offerings of these securities.[17] Additionally, funds that invest only in securities of issuers located in particular countries often employ investment advisers located in those countries, many of which advisers are affiliated with major underwriters in those countries.[18] As a result of these developments, funds that invest in foreign securities increasingly are subject to the prohibitions of section 10(f), but often cannot rely upon rule 10f–3 for purchases of these securities because the securities frequently are not registered under the Securities Act.[19]

The Commission believes that amendments to rule 10f–3 may be desirable in light of these changes. Because the incentives that could lead fund affiliates to seek to use fund assets to facilitate underwritings are substantially the same today as they were in 1940, however, the concerns underlying section 10(f) remain important.[20] The proposed amendments are designed to balance these concerns with the need for funds to have more flexibility to purchase securities when their affiliated underwriters are members of syndicates.

II. Discussion

A. Quantity Limitations

1. Amount Purchased

Rule 10f–3 currently prohibits funds advised by the same investment adviser from purchasing, in the aggregate, more than 4% of the principal amount of the offering, or $500,000, whichever is greater, but in no event greater than 10% of the offering.[21] The Commission is proposing to amend the percentage

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Permits an Investment Company to Acquire Securities Underwritten by an Affiliate of that Company, Investment Company Act Release No. 14924 (Jan. 29, 1986), 51 FR 4386 (''1986 Concept Release''). In response, the Commission received 11 letters commenting on nearly every aspect of the rule. The Commission's Division of Investment Management (''Division'') further evaluated the rule in connection with its 1992 study of the Investment Company Act. The Division recommended at that time that the Commission amend rule 10f–3 to permit the purchase of foreign securities. *See Division of Investment Management, U.S. Securities and Exchange Commission, Protecting Investors: A Half Century of Investment Company Regulation* 499–500 (1992).

[10] In 1980, there were 564 funds with total assets of $134.8 billion. By December 1995, there were 5,789 funds with total assets of over $2.8 trillion. Investment Company Institute, Press Release (Jan. 25, 1996).

[11] *See, e.g., The Boom in IPOs*, Bus. Wk., Dec. 18, 1995, at 64, 68 (stating that ''mutual funds are major buyers of new equity issues'').

[12] The average size of a municipal bond fund, for example, has increased at a much greater rate than the average size of a municipal bond offering. In 1980, the average municipal bond fund had $69.5 million in assets and the average municipal bond offering was $8.5 million. *Investment Company Institute, 1982 Mutual Fund Fact Book* 27; *Investment Company Institute*, 1986 *Mutual Fund Fact Book* 19; *Bond Buyer*, 1990 *Yearbook* 38. In 1995, the average municipal bond fund had more than tripled in size, with $249.6 million in assets, while the average municipal bond offering, $15.2 million, had not even doubled in size. *See* Investment Company Institute, Press Release (Jan. 25, 1996); *1995 Year-End Statistics Supplement, Bond Buyer*, Jan. 26, 1996, at 13A. *See also infra* note and accompanying text.

[13] *See, e.g.*, Shawn Tully, *Can Lehman Survive?, Fortune*, Dec. 11, 1995, at 154; *see also* Helene Duffy, *Few to Get Fewer in Investment Banking, Bank Mgmt.*, Mar. 1991, at 8; *From the Many, Perhaps Just a Few*, Bus. Month, Feb. 1988, at 69. Some commentators have suggested that there has been an increased concentration in the municipal securities industry as firms have departed from that business. *See, e.g.*, Michael Stanton, *Chemical Securities to Close Muni Division; 50 Jobs Lost, Bond Buyer*, Jan. 17, 1996, at 1; *Muni Market Liquidity Not Seen Growing Significantly, Sec. Industry Daily*, Sept. 29, 1995, at 15.

[14] *See, e.g.*, Mercedes M. Cardona, *Wall St. Managers Pay Off, Pensions & Investments*, Sept. 5, 1994, at 3 (''money managers owned by big Wall Street brokerage and investment banking firms increasingly are contributing to their parents' bottom lines, while underwriting and brokerage activities slow down''); Geoffrey Smith, *This Little Broker Went to Market—And Got Big, Bus. Wk.*, Jan. 27, 1992, at 76 (describing the development and increasing growth of a broker-dealer affiliate of the nation's largest fund complex). According to statistics compiled by the Division, in 1970 only 8 of the top 25 underwriters (ranked by percentage of amount of securities underwritten, giving full credit to the lead underwriter) were affiliated with funds. By 1980, that number had risen to 13. By 1995, 23 of the top 25 underwriters were affiliated with fund groups.

[15] According to statistics compiled by the Division, 21 funds, with aggregate assets of $2.2 billion, invested primarily in foreign securities as of December 1980. By December 1995, 682 funds, with aggregate assets of $230.3 billion, invested primarily in foreign securities. *See* Investment Company Institute, Press Release (Jan. 25, 1996).

[16] *See, e.g.*, Michael Hurley, *Comments: International Debt and Equity Markets: U.S. Participation in the Globalization Trend*, 8 *Emory Int'l L. Rev.* 701 (1994) (describing the internationalization of the securities markets); William Glasgall, *Who's Afraid of the Global Markets? Not U.S. Investors, Bus. Wk.*, Sept. 18, 1995, at 70 (describing how U.S. investors ''continue to roam the world in search of portfolio diversification and growth'').

[17] *See, e.g.*, Michael R. Sesit, *Top Dogs: U.S. Financial Firms Seize Dominant Role In the World Markets, Wall St. J.*, Jan. 5, 1996, at A1; *see also* Michael Carroll, *As the Cycle Turns, Inst. Inv.*, Sept. 1994, at 138–39 (describing how U.S. firms are in a ''preeminent worldwide position in underwriting'').

[18] *See, e.g.*, Irish Investment Fund, Investment Company Act Release Nos. 20220 (Apr. 14, 1994), 59 FR 19035 (Notice of Application) and 20286 (May 10, 1994), 56 SEC Docket 1843 (Order); Brazilian Equity Fund, Investment Company Act Release Nos. 19601 (July 28, 1993), 58 FR 41533 (Notice of Application) and 19650 (Aug. 24, 1993), 54 SEC Docket 1840 (Order); First Philippine Fund, Investment Company Act Release Nos. 19034 (Oct. 16, 1992), 57 FR 48534 (Notice of Application) and 19096 (Nov. 12, 1992), 52 SEC Docket 2436 (Order).

[19] If a fund is prohibited by section 10(f) from purchasing a security during the existence of an underwriting syndicate, the fund theoretically can wait until the syndicate is completed and purchase the security in the market. This option has disadvantages, however. *See infra* note and accompanying text.

[20] *See* I *Louis Loss & Joel Seligman, Securities Regulation* 378 (1989) (''The high turnover of underwriting capital in this country means that investment bankers for the most part cannot retain the securities they underwrite for any length of time even if they should want to.''); *id.* at 379–80 (''It is a simple fact * * * that diminution of risk and its by-product, speed, are the keynotes in distribution.''). Members of the fund industry, on the other hand, have observed that the increased contributions of funds to the revenues of major financial conglomerates, and the increased scrutiny given funds by the financial press, have reduced the likelihood that funds would be used to facilitate underwritings to the disadvantage of fund shareholders. *See, e.g.*, Letter from IDS Financial Services, Inc. to John P. Wheeler, III, Secretary, SEC, Apr. 4, 1986 (commenting on 1986 Concept Release, File No. S7–3–86).

[21] Rule 10f–3(d).

limit to permit funds relying on the rule to purchase up to the greater of 10% of the principal amount of an offering, or $1,000,000 (but not more than 15% of the offering).[22] This proposed change is designed to respond to the increasing size of funds and the increasing concentration in the underwriting industry in general.

When originally adopted in 1958, rule 10f–3 limited funds to purchasing 3% of the amount offered by the syndicate in which the affiliated underwriter participated. The exemptions from section 10(f) obtained by funds prior to 1958 generally had involved purchases that would not exceed this amount.[23] In 1979, the Commission increased the percentage limit to its current level.[24]

The current percentage limit, in some instances, may be more restrictive than is necessary for the protection of fund investors. A fund that is limited to purchasing 4% of an offering must, if it wishes to purchase more than that amount, wait until the syndicate has closed and purchase the securities in the secondary market. This delay may result in a fund paying a significantly higher price for the securities and incurring significant additional transaction costs.[25] Thus, a fund that is restricted by the percentage limit in rule 10f–3 may not be able to purchase desirable securities at prices that would benefit its portfolio. Large funds or funds in a large fund complex also may find it inefficient to purchase only 4% of an offering, particularly if the total offering amount is small. For these funds, 4% of an offering may be too small an amount to have any effect on the fund's portfolio.[26] The portfolio manager of such a fund may then decide not to purchase the security at all.

Notwithstanding these potential disadvantages, the percentage limit would appear to limit the possibility that securities will be ''dumped'' on an affiliated fund. The percentage limit provides an indication that a significant portion of the offering is being purchased by persons other than the affiliated fund. In view of its administrative experience with rule 10f–3, however, the Commission believes that the percentage limit can be raised to afford funds additional flexibility. The proposed 10% purchase limit would continue to provide assurance that a significant portion of the offering is being distributed to persons not affiliated with the fund.

2. Percentage of Fund Assets

Rule 10f–3 currently prohibits a fund from using more than 3% of its assets to acquire securities in a transaction subject to the rule (the ''3% limit'').[27] The Commission is proposing to eliminate this condition. The Commission believes that the other provisions of rule 10f–3 provide sufficient protection against dumping. In addition, the diversification provisions of the Investment Company Act provide shareholders of most funds with similar protections.[28]

3. Request for Comment on Quantity Limitations

The Commission requests comment on the percentage limit and the 3% limit generally. Does the percentage limit continue to serve a useful regulatory purpose? Should the percentage limit be retained at all? Would increasing the percentage limit to 10% provide sufficient flexibility to funds while addressing the concerns underlying section 10(f)?[29] Would a higher limit (such as 15% or 20%) be appropriate? Does the 3% limit serve a useful purpose, and if so, should the limit be retained or raised?

The Commission also requests comment whether other types of quantity limits, in addition or as an alternative to the current and proposed limits, are appropriate or necessary to reduce the risk that an underwriter will seek to cause an affiliated fund to purchase unmarketable securities. One industry commenter, for example, has suggested raising the percentage limit dramatically while limiting the percentage of a fund's assets that may consist of securities acquired in rule 10f–3 transactions.[30] Another possible approach would be to limit the amount of an offering all funds affiliated with members of the underwriting syndicate may purchase. Commenters are requested to provide specific suggestions for these types of provisions and indicate whether they would supplement or replace existing quantity limitations in the rule.

B. Purchases of Foreign Securities

Funds cannot rely on rule 10f–3 to purchase foreign securities from syndicates in which their affiliated underwriters participate when those offerings are not registered under the Securities Act. As a result, several funds have, over time, applied for orders from the Commission that would exempt them from section 10(f) and allow them to make these purchases.[31] The proposed amendments would permit funds to rely on rule 10f–3 to purchase foreign securities in circumstances similar to those described in prior Commission orders.

The Commission has granted orders permitting funds to purchase foreign securities in accordance with rule 10f–3 when the securities have been offered in foreign public offerings that have characteristics similar to those present in offerings registered under the Securities Act.[32] One important factor present in all of the orders, for example,

[22] Proposed rule 10f–3(f).

[23] *See* 1958 Adopting Release, *supra* note 6.

[24] *See* 1979 Adopting Release, *supra* note 6.

[25] In many instances, particularly in the equity market, the price of a security increases, sometimes dramatically, after an initial public offering. *See, e.g.*, I Louis Loss & Joel Seligman, *supra* note 20, at 333 n.28; Jonathan A. Shayne & Larry D. Soderquist, *Inefficiency in the Market for Initial Public Offerings,* 48 Vand. L. Rev. 965 (1995). There are additional potential costs to purchasing securities in the secondary market. In secondary market purchases, funds would be required to pay brokerage commissions that they usually would not pay when purchasing directly in an underwritten offering. A fund that must wait until the dissolution of the underwriting syndicate to purchase more than 4% of an offering also may not have the opportunity to purchase the amount of the security that is desirable for its portfolio because of limited supply. This particularly would be the case for popular securities that are in high demand.

[26] *See, e.g.*, Letter from Alliance Capital Management Corp. to John P. Wheeler, III, Secretary, SEC, Apr. 14, 1986 (commenting on 1986 Concept Release, File No. S7–3–86); Application of First Funds, File No. 812–9248; *see also supra* note 12 and accompanying text. In the case of municipal securities, smaller blocks of securities often are more difficult to sell than larger blocks. If a fund manager is able to purchase only a small block of municipal securities because of the percentage limit in rule 10f–3, the liquidity of the fund's portfolio may be adversely affected.

[27] Rule 10f–3(e).

[28] Section 5(b)(1), 15 U.S.C. 80a–5(b)(1), of the Investment Company Act, for example, generally limits a diversified fund to investing, with respect to 75% of its assets, no more than 5% of its assets in the securities of a single issuer.

[29] The Commission notes that a factor in determining the percentage limit is the possibility that several underwriters would together agree to underwrite an offering and sell the entire offering to their affiliated funds. The higher the percentage limit, the fewer the number of underwriters necessary to make such an agreement.

[30] Letter from Smith Barney Inc. to Kenneth J. Berman, Assistant Director, Office of Regulatory Policy, Division of Investment Management, SEC, Feb. 28, 1996 (available in public file S7–7–96).

[31] *See, e.g.*, Brazilian Investment Fund, Investment Company Act Release Nos. 19301 (Mar. 1, 1993), 58 FR 12613 (Notice of Application) and 19366 (Mar. 30, 1993), 53 SEC Docket 2139 (Order); France Growth Fund, Investment Company Act Release Nos. 19097 (Nov. 13, 1992), 57 FR 54627 (Notice of Application) and 19151 (Dec. 9, 1992), 52 SEC Docket 3001 (Order). The orders granted by the Commission generally have required the applicants to comply with all of the provisions of rule 10f–3 except for the Securities Act registration requirement.

[32] *See, e.g.*, The Mexico Fund, Investment Company Act Release Nos. 20156 (Mar. 23, 1994), 59 FR 14946 (Notice of Application) and 20225 (Apr. 19, 1994), 56 SEC Docket 1455 (Order); The New Germany Fund, Investment Company Act Release Nos. 19353 (Mar. 24, 1993), 58 FR 16723 (Notice of Application) and 19421 (Apr. 20, 1993), 53 SEC Docket 2481 (Order); The First Philippine Fund, *supra* note 18.

has been that the securities were publicly offered and distributed at a uniform public offering price.[33] Another important factor has been that the applicable laws or regulations of the country in which the public offering was taking place required information about the issuer to be made available to the public. These and other factors outlined in the orders suggested that the securities would be widely distributed, that a wide range of market participants would agree that the offering price of the securities was fair, and that a secondary market for the securities would likely develop.

The Commission proposes to amend rule 10f–3 to permit purchases of foreign securities in circumstances in which the offerings have characteristics similar to those described above. The proposed amendments would permit a fund to purchase, through an affiliated underwriting syndicate, securities issued by a foreign issuer and not registered under the Securities Act if they are issued in either an ''Eligible Foreign Offering'' or a ''Foreign Issuer Rule 144A Offering,'' described below.[34] The fund also would be required to comply with all other provisions of rule 10f–3.

1. Eligible Foreign Offering

a. General. The proposed amendments would define an Eligible Foreign Offering as a public offering, conducted under the laws of a country other than the United States, of the securities of a foreign issuer.[35] The offering would be required to be subject to regulation by a Foreign Financial Regulatory Authority (''FFRA''), as defined in the Investment Company Act, in the country in which the public offering occurs.[36] Thus, an offering would meet the terms of the proposed definition if it is conducted in a country that has laws, rules or regulations regarding public offerings. An offering also would fall within the definition if an organization such as a stock exchange in that country has rules that regulate the offering of the securities. The Commission requests comment whether the proposed requirement for regulation by a FFRA appropriately recognizes that securities regulatory schemes differ among countries. Comment is requested whether a narrower definition of regulatory scheme would be appropriate for the protection of investors. Are additional or alternative provisions, such as a requirement that the country have laws imposing liability for misleading disclosure, or a requirement that the country have a system for the registration of securities, appropriate or necessary for the protection of investors?

The public offering requirement may provide some assurance that a market for the securities will develop. The Commission requests comment whether additional conditions, such as a minimum market float or a requirement that there be no legal restrictions on transferability, are necessary to provide adequate assurance that a market for the securities will exist after the offering is complete. The Commission also requests comment whether the proposal should require all foreign securities purchased pursuant to the rule to be listed on a securities exchange, either as an alternative or an addition to the proposed provisions. Would a listing requirement provide greater assurance that the securities are widely distributed?

b. Disclosure. An offering subject to regulation by a FFRA would meet the terms of the definition of Eligible Foreign Offering only if, under applicable law or the rules of the applicable FFRA, the issuer of the securities is required to disclose information about the issuer and the offering to prospective purchasers.[37] The proposed amendments also would require that financial statements, audited in accordance with the accounting standards of the appropriate country, for the two years prior to the offering, be made available to the public and prospective purchasers in connection with the offering.[38]

The proposed rule would not set objective disclosure standards, other than the financial statement requirement, that must be met in order to comply with the rule. The Commission requests comment whether the rule should be amended to provide specific standards of disclosure that would be applicable to purchases of foreign securities made pursuant to the rule.

c. Offering Price. Under the proposed definition of Eligible Foreign Offering, the foreign securities would have to be offered at a fixed price to all purchasers in the offering. The single public offering price requirement is designed to enable a fund to comply with the provision of rule 10f–3 that requires the fund to purchase the securities at not more than the public offering price prior to the end of the first business day after the first date on which the securities are offered to the public.[39] The Commission believes the proposed single price offering requirement is consistent with the purposes of section 10(f) because it would preclude an underwriter from obtaining an advantage for the syndicate by causing an affiliated fund to purchase securities from the syndicate at a price that is higher than the price offered to unaffiliated purchasers.

An exception from the single offering price requirement would be available if applicable law requires an issuer to offer the securities at a lower price to existing securities holders.[40] The Commission requests comment whether there are other discrete classes of persons to whom discounts are offered, other than persons who may control a company through ownership or influence over the company's operations, that should be included in this exception. In privatization transactions, for example, citizens of the country that formerly owned the enterprise often are offered the securities at a discount.

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[33] At least one applicant that received a Commission order invested in securities in a country where existing shareholders could be offered securities on terms different than those offered to other potential purchasers. *See* The New Germany Fund, *supra* note 32.

[34] A ''foreign issuer'' would be defined in the same manner as it is in rule 405 under the Securities Act, 17 CFR 230.405, to mean any issuer which is a foreign government, a national of any foreign country or a corporation or other organization incorporated or organized under the laws of any foreign country.

[35] The proposed amendments do not affect the obligation of any issuer, whether domestic or foreign, to comply with U.S. securities laws. The proposed definition of Eligible Foreign Offering, for example, would not affect an issuer's obligation to determine whether the offering is conducted in such a manner as to bring it within the reach of the registration requirements of section 5 of the Securities Act.

[36] Proposed rule 10f–3(k)(1)(i). ''Foreign Financial Regulatory Authority'' is defined in section 2(a)(50) of the Investment Company Act, 15 U.S.C. 80a–2(a)(50), generally as any (A) Foreign securities authority, (B) other governmental body or foreign equivalent of a self-regulatory organization empowered by a foreign government to administer or enforce its laws relating to certain financial activities, or (C) membership organization a function of which is to regulate the participation of its members in such financial activities.

A ''foreign securities authority'' is defined in section 2(a)(49) of the Investment Company Act, 15 U.S.C. 80a–2(a)(49), as any foreign government or any governmental body or regulatory organization empowered by a foreign government to administer or enforce its laws as they relate to securities matters.

[37] This condition would not require that the issuer become subject to an ongoing disclosure regime. The condition would be satisfied if information about the issuer and the offering were required to be disclosed to prospective purchasers in connection with the sale of the securities.

[38] Proposed rule 10f–3(k)(1)(iv). The proposed amendments would not specify the format of the financial statements that must be provided in recognition that financial reporting standards differ from country to country.

[39] *See* rule 10f–3 (a)(2) (paragraph (b) of rule 10f–3 as proposed to be amended).

[40] *See supra* note 33.

2. Foreign Issuer Rule 144A Offerings

Many fund purchases of foreign securities are made in transactions (''rule 144A placements'') that are exempt from the registration provisions of the Securities Act and that qualify the purchased securities as eligible to be resold pursuant to rule 144A under the Securities Act (''rule 144A-eligible securities'').[41] Rule 144A is a non-exclusive safe harbor that exempts from the registration provisions of the Securities Act resales of securities to certain large institutions, known as Qualified Institutional Buyers (''QIBs'').[42] Typically, a rule 144A placement involving a foreign issuer's securities is part of a larger global offering of those securities.[43] Frequently, a global offering is divided into several tranches—one for the issuer's home country, one for the United States, and one or more for other countries. The securities in the U.S. tranche are sold in either a registered public offering or an offering that is exempt from registration under the Securities Act. Often, the U.S. tranche is sold only to institutions that qualify as QIBs. Usually, the price for the securities is uniform across all the tranches and the issuer prepares an offering document that provides detailed information about the issuer and the offered securities.[44] Securities purchased by a fund in a rule 144A placement are transferable to another QIB in the United States, and may be sold freely in a foreign market (assuming foreign law permits such sale).[45]

In order to increase the flexibility of affiliated funds to purchase securities in these types of transnational offerings, the proposed amendments would permit a fund to purchase securities in a Foreign Issuer Rule 144A Offering, subject to the other conditions of rule 10f–3 (other than the Securities Act registration requirement).[46] A Foreign Issuer Rule 144A Offering generally would be a distribution of securities of a foreign issuer, made exclusively to QIBs, if the securities would be eligible to be resold pursuant to rule 144A.[47] In addition, the proposed amendments would require that securities of the same class be offered in a concurrent Eligible Foreign Offering.[48] This condition is designed to provide some assurance that there is a widespread distribution of securities that are fungible with the rule 144A securities purchased by the fund.

Consistent with the purpose of section 10(f), the proposed amendments would require a fund purchasing securities in a Foreign Issuer Rule 144A Offering to pay no more than the public offering price in the concurrent Eligible Foreign Offering or the price paid by each other QIB, whichever is lower.[49] This provision is designed to provide assurance that a fund does not pay more for the securities than it would if it could engage in arm's length negotiations as to the price of the securities.

The proposed amendments would permit funds to purchase securities in rule 144A placements of foreign issuers. The Commission recognizes that rule 144A placements also often are used by U.S. issuers, and requests comment whether rule 10f–3 should permit purchases of rule 144A-eligible securities of domestic issuers, subject to conditions that protect investors by reducing the likelihood that dumping of unmarketable securities will occur.[50] The conditions applicable to Foreign Issuer Rule 144A Offerings and Eligible Foreign Offerings, however, generally could not be made applicable to domestic rule 144A placements.[51] Commentators in favor of expanding the rule to permit the purchase of securities of domestic issuers in rule 144A placements should suggest alternative conditions.

3. General Request for Comment

The Commission believes that the proposed conditions for purchases of foreign securities should provide assurance that the purposes underlying rule 10f–3 will be met in foreign offerings. Nonetheless, the Commission requests comment on its overall approach to permitting purchases of foreign securities under rule 10f–3. Commenters are encouraged to suggest specific alternatives that would provide flexibility without diminishing investor protection. The Commission also requests comment whether the proposed standards for an Eligible Foreign Offering and a Foreign Issuer Rule 144A Offering are sufficiently clear. The Commission considered alternatives to the proposed approach, such as specifically identifying countries in which purchases may be made, but believes that its proposed approach

[41] 17 CFR 230.144A. In 1993, funds purchased more foreign equity securities in rule 144A placements than did any other type of purchaser. *See* SEC, *Staff Report on Rule 144A* 15 (1994) (hereinafter *Staff Report*). The Commission has received applications from several funds requesting exemptive relief from section 10(f) for purchases of foreign securities in transactions that would produce rule 144A-eligible securities. *See, e.g.,* Application of the Brazilian Investment Fund, Inc. *et al.*, File No. 812–9676; Application of Merrill Lynch Balanced Fund For Investment and Retirement *et al.*, File No. 812–8346.

[42] Under rule 144A, the seller must reasonably believe that the purchaser is a QIB. A QIB is an institution of a type listed in rule 144A and owning or investing on a discretionary basis at least $100 million of securities. *See* 17 CFR 230.144A(a)(1). Many funds qualify as QIBs in their own right, and others qualify because they are part of a ''family'' of funds that own, in the aggregate, at least $100 million in securities. 17 CFR 230.144A(a)(1)(iv).

[43] One of the purposes of rule 144A was to encourage foreign issuers to access the U.S. capital markets. *See* Securities Act Release No. 6862 (April 30, 1990), 55 FR 17933. According to statistics compiled by the Commission's Division of Corporation Finance, from the adoption of rule 144A through December 31, 1994, approximately $39 billion of equity and debt securities relating to more than 480 foreign issuers were sold in rule 144A placements.

[44] Although most foreign rule 144A placements appear to be priced the same as concurrent foreign offerings, there is no regulatory requirement that the securities be priced in this manner. *See Staff Report, supra* note 41, at 26. It has been suggested, however, that most rule 144A transactions are sold in underwriting arrangements with terms and conditions substantially similar to those applicable to registered public offerings. 1 E. Greene et al., U.S. Regulation of the International Securities Markets: A Guide for Domestic and Foreign Issuers and Intermediaries 141 (1993). Rule 144A requires an issuer to provide certain information about the issuer that the purchaser of the securities may request, including financial information for its two most recent fiscal years of operation. *See* 17 CFR 230.144A(d)(4). The rule exempts from this information requirement foreign governments and foreign private issuers that furnish information to the Commission pursuant to rule 12g3–2(b), 17 CFR 240.12g3–2(b), under the Securities Exchange Act of 1934, 15 U.S.C. 78a *et seq.* (''Exchange Act''). *See* 17 CFR 230.144A(d)(4)(i).

[45] Regulation S under the Securities Act generally permits the sale of securities owned by a U.S. person into a foreign market if certain conditions are met. *See* 17 CFR 230.901 *et seq.*

[46] The proposed amendments would in no way affect the determination that must be made by fund boards of directors whether a security purchased by the fund in a rule 144A placement is deemed a liquid security for purposes of the fund's liquidity policies. *See* Resale of Restricted Securities, Securities Act Release No. 6862 (Apr. 23, 1990), 55 FR 17933.

[47] Rule 144A provides that a person who offers or sells securities in compliance with rule 144A is not deemed to be an underwriter of such securities for purposes of section 2(11) of the Securities Act. 17 CFR 230.144A(c). Rule 144A, however, does not limit the scope of section 10(f).

[48] Proposed rule 10f–3(k)(4). The definition of ''foreign issuer'' for purposes of rule 10f–3 would not be limited to ''foreign private issuers,'' as defined in rule 405, 17 CFR 230.405, under the Securities Act. A foreign issuer that is not a foreign private issuer may have a substantial presence in the United States (either through securities ownership or operation of business, or both). Under the amended rule, for a fund to purchase securities of that issuer in a rule 144A placement, the issuer would be required to have a concurrent Eligible Foreign Offering of securities of the same class in a foreign country.

[49] Proposed rule 10f–3(b)(2). The proposed amendments would provide that a fund will be deemed to have satisfied this condition if it reasonably relies on written statements of the seller. Proposed rule 10f–3(h).

[50] *See Staff Report, supra* note , at 3–4.

[51] The requirement that there be a concurrent public offering of securities of the same class, for example, could not be met because rule 144A is not available for transactions in securities if, at issuance, securities of the same class were listed on a national securities exchange.

would protect investors while also affording greater flexibility to funds.

The proposed amendments would not differentiate between securities issued by foreign companies and those issued by foreign governments. The definition of Eligible Foreign Offering, therefore, would permit an affiliated fund to purchase foreign government securities if the offering of those securities otherwise meets the conditions of the definition. Comment is requested, however, whether these conditions are appropriate for purchases of foreign government securities that could be subject to section 10(f).

Rule 10f–3 currently requires fund directors to adopt procedures pursuant to which a fund may purchase securities in reliance on the rule.[52] The Commission requests comment on the role of fund directors in determining compliance with the proposed foreign securities provisions. In particular, the Commission asks commenters to consider whether the existing requirements for the establishment and review of procedures are sufficient to cover the new proposals.

C. Group Sales

A ''group sale'' is a sale of municipal securities resulting from a ''group order,'' which is an order for securities for the account of all members of a syndicate in proportion to their respective participations in the syndicate.[53] Rule 10f–3 prohibits a fund from purchasing a security, directly or indirectly, from its affiliated underwriter, and, in effect, provides that a purchase from a syndicate manager that is designated as a group sale is deemed a purchase from the affiliated underwriter.[54] These provisions are designed to ensure that a purchase permitted by rule 10f–3 does not violate section 17(a) of the Investment Company Act, which prohibits a fund from purchasing securities from an affiliate or an affiliate of an affiliate.[55]

The prohibition in rule 10f–3 on group sales may act to the detriment of funds that invest in municipal bonds. The rules of the Municipal Securities Rulemaking Board (''MSRB''), which govern the sale of municipal securities, require a syndicate that is offering municipal securities to establish a priority by which orders for the securities will be filled.[56] Frequently, group orders are designated to receive first priority.[57] Thus, if a municipal securities offering were oversubscribed, it is possible that only prospective purchasers who placed group orders would be able to purchase the securities being offered. A fund that is prohibited by rule 10f–3 from placing group orders would be precluded from purchasing any securities in that offering. Because of the potential cost of this prohibition to municipal bond funds and their shareholders, particularly during times in which demand for municipal securities is increasing and supply of these securities is decreasing, the Commission believes that funds subject to rule 10f–3 should be given more flexibility to place group orders for municipal securities.[58]

The proposed provision that would permit group sales contains two conditions designed to limit the likelihood that a group sale would be motivated primarily by an affiliated underwriter's intention to be the primary beneficiary of the group sale. First, a purchase designated as a group sale could be made only if the syndicate has established that orders designated as group orders have first priority, or that only group orders will be filled.[59] Second, a purchase designated as a group sale would be permitted only if, at the time of the sale, the affiliated underwriter is not committed to underwriting more than 50% of the principal amount of the offered securities.[60] In determining whether the conditions have been satisfied, the proposed amendments would permit a fund reasonably to rely upon the written statements of a member of the syndicate.[61]

Absent an exemption by order or rule, section 17(a) of the Investment Company Act could prohibit a fund from purchasing securities in a group sale. To clarify that a purchase of municipal securities in a group sale permitted by rule 10f–3 also is exempt from section 17(a), the Commission is proposing new rule 17a-10. The new rule would exempt any purchase of municipal securities in a group sale that complies with rule 10f–3 from section 17(a)(1).

The Commission requests comment whether permitting funds to purchase through group sales would give needed flexibility to funds. To further reduce the likelihood that the syndicate is giving group sales first priority to benefit the affiliated underwriter, should the proposed amendments require there to be at least a certain number of syndicate members for a fund to take advantage of the provision permitting group sales? Comment also is requested whether there are other arrangements similar to group sales with respect to securities other than municipal securities and whether rule 10f–3 should be amended to permit these types of arrangements.

D. Reporting and Recordkeeping

The Commission proposes eliminating the current requirement that funds report all rule 10f–3 transactions to the Commission in their semi-annual reports on Form N-SAR by filing an

[52] Rule 10f–3(h). The Commission proposes to amend this requirement to clarify that the board of directors must *approve*, rather than *adopt*, procedures for the purchase of securities of rule 10f–3. Proposed rule 10f–3(i)(1). The Commission believes that this change would more accurately reflect the role of the board of directors of approving policies and procedures developed by fund management.

[53] See Municipal Securities Rulemaking Board (''MSRB'') Rule G–11(a)(iii), MSRB Manual (CCH) ¶3551; *see also* The Galaxy Fund *et al.*, Investment Company Act Release No. 20660 (Oct. 26, 1994) (Notice of Application).

[54] Rule 10f–3(f) provides that a purchase from a syndicate may not be made from, or directly or indirectly benefit, an affiliated underwriter. The rule implicitly permits certain purchases of municipal securities to indirectly benefit an affiliated underwriter, however, so long as such purchases are not designated as group sales or otherwise allocated to the account of the affiliated underwriter. *See* Exemption of Acquisition of Securities During the Existence of Underwriting Syndicate, Investment Company Act Release No. 10592 (Feb. 13, 1979) (proposing amendments to rule 10f–3).

[55] Rule 10f–3 currently defines ''municipal securities'' by reference to section 3(a)(29) of the Exchange Act. *See* rule 10f–3(a)(1)(ii). The proposed rule would continue to refer to the definition under the Exchange Act. *See* proposed rule 10f–3(k)(7).

[56] MSRB Rule G–11(e), MSRB Manual (CCH) ¶3551.

[57] *See, e.g.*, Public Securities Association, Fundamentals of Municipal Bonds 80 (1990). After group orders, ''designated orders'' generally are next in priority to be filled. A designated order is an order submitted by a member of the syndicate on behalf of a buyer on which all or a portion of the sale is to be credited to certain members of the syndicate. MSRB, Glossary of Municipal Securities Terms 34 (1985). Because rule 10f–3 prohibits funds that are purchasing municipal securities from placing group orders, these funds generally must place designated orders, designating underwriters other than affiliated underwriters to be credited with the sale.

[58] The increase in the number of municipal bond funds over the past 15 years has contributed to an increase in demand for municipal securities. *See, e.g.*, Investment Company Institute, *Trends in Mutual Fund Activity*, (Sept. 1995); Investment Company Institute, 1986 Mutual Fund Fact Book; Investment Company Institute, 1982 Mutual Fund Fact Book. The supply of newly issued municipal securities varies from year to year, depending upon a number of factors, including interest rates, tax considerations and political factors. Between 1986 and 1995, for example, the annual amount of issuances of new-money municipal securities ranged from a low of approximately $59.4 billion in 1987 to a high of $119.3 billion in 1993. *See 1995 Year-End Statistics Supplement*, Bond Buy., Jan. 26, 1996, at 16A.

[59] Proposed rule 10f–3(g)(2)(i).

[60] Proposed rule 10f–3(g)(2)(ii).

[61] Proposed rule 10f–3(h). MSRB rule G–11(f) requires a member of a municipal securities syndicate, upon request, to promptly furnish in writing information about the syndicate's priority provisions. A fund attempting to comply with rule 10f–3 could therefore easily obtain the required information.

exhibit setting forth certain details about each transaction.[62] Information about transactions that rely on rule 10f–3 currently are required to be kept with other records pursuant to rule 10f–3 and is available to Commission staff during periodic on-site examinations of funds and investment advisers.[63] The Commission thus believes that it is unnecessary for funds to continue to file these reports. The Commission requests comment whether any changes to the reporting and recordkeeping requirements of rule 10f–3, other than the elimination of the requirement to report on Form N–SAR, are necessary.

III. General Request for Comments

Any interested persons wishing to submit written comments on the rule changes that are the subject of this Release, to suggest additional changes, or to submit comments on other matters that might have an effect on the proposals contained in this Release, are requested to do so. Comment is specifically requested whether the Commission should amend or eliminate conditions in rule 10f–3 other than those addressed in this Release. Does the requirement that the issuer have three years of operations and, in the case of municipal securities, have at least an investment grade rating, for example, continue to serve the purposes of rule 10f–3? Suggestions for such amendments should explain how they are consistent with the protection of investors and the purposes of section 10(f). The Commission also requests comments whether rule 10f–3 should be amended to permit the purchase of other classes of securities, such as U.S. government securities, that currently are not addressed by the rule, and the extent to which the conditions of the rule should apply to such purchases.[64]

IV. Cost/Benefit Analysis

The proposed amendments to rule 10f–3 would increase the flexibility for funds to purchase securities during the existence of a syndicate in which an affiliated underwriter participates. These amendments would benefit funds, which would be able to (i) purchase foreign securities in reliance upon rule 10f–3, without having to seek an exemptive order from the Commission, (ii) in many cases, purchase more desirable quantities of securities at advantageous prices, and (iii) purchase municipal securities that are in high demand. Funds also would no longer be required to file information about rule 10f–3 transactions on Form N-SAR. The potential benefits to fund investors of the proposed amendments are better investment performance, lower fund expenses, and less paperwork burden.

The costs to funds and investors of the proposed amendments are minimal. Fund advisers and boards of directors would be required to determine whether purchases of foreign securities and municipal securities in group sales comply with the proposed standards. Rule 10f–3, however, currently has standards that must be met for purchases permitted under the rule. Thus, the additional cost of determining compliance with the standards related to foreign securities and municipal securities in group sales should be minimal. These costs likely would be outweighed by the potential benefits to funds and investors described above.

V. Paperwork Reduction Act

Certain provisions of the proposed amendments to rule 10f–3 contain ''collection of information'' requirements within the meaning of the Paperwork Reduction Act of 1995 (44 U.S.C. 3501 *et seq.*), and the Commission has submitted the proposed amendments to the Office of Management and Budget for review in accordance with 44 U.S.C. 3507(d). The title for the collection of information is ''Exemption for the Acquisition of Securities During the Existence of an Underwriting Syndicate.'' The Supporting Statement to the Paperwork Reduction Act submission notes that the proposed amendments to rule 10f–3 would permit funds to purchase foreign securities and to purchase municipal securities in group sales, if certain conditions are met. The proposed amendments also would permit funds to purchase up to the greater of 10% of the offering amount or $1,000,000 (but not greater than 15% of the offering amount).

The submission further notes that the amendments would require funds that wish to rely upon the proposed new provisions to amend the procedures that are required by the rule to account for purchases of foreign securities and municipal securities in group sales. Adoption, and occasional revision, of procedures is important to ensure continual board oversight of transactions relying upon rule 10f–3. The Division of Investment Management estimates that 600 funds rely upon rule 10f–3 each year, and that 140 of those funds purchase municipal and/or foreign securities (although not all such funds rely upon rule 10f–3 to purchase such securities). It is estimated that the proposed amendments would increase the recordkeeping burden of funds that invest in foreign and/or municipal securities by an estimated 0.50 hours per fund per year. Thus, the total additional burden of the proposed amendments is estimated to be 70 hours.

Pursuant to 44 U.S.C. 3506(c)(2)(B), the Commission solicits comments concerning: whether the proposed collection of information is necessary for the proper performance of the function of the Commission, including whether the information shall have practical utility; on the accuracy of the Commission's estimate of the burden of the proposed collection of information; on the quality, utility, and clarity of the information to be collected; and whether the burden of collection of information on those who are to respond, including through the use of automated collection techniques or other forms of information technology, may be minimized.

Persons desiring to submit comments on the collection of information requirements should direct them to the Office of Management and Budget, Attention: Desk Officer for the Securities and Exchange Commission, Office of Information and Regulatory Affairs, Washington D.C. 20503, and should also send a copy of their comments to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth St., N.W., Washington, D.C. 20549 with reference to File No. S7–7–96. The Office of Management and Budget is required to make a decision concerning the collection of information between 30 and 60 days after publication, so a comment to the Office of Management and Budget is best assured of having its full effect if the Office of Management and Budget receives it within 30 days of publication.

VI. Summary of Regulatory Flexibility Analysis

The Commission has prepared an Initial Regulatory Flexibility Analysis in accordance with 5 U.S.C. 603 regarding amendments to rule 10f–3 under the Investment Company Act. The analysis indicates that the proposed amendments would affect small entities in the same manner as other entities subject to section 10(f), but that the proposed amendments increase flexibility for all funds. Cost-benefit information reflected in the ''Cost/Benefit Analysis'' section

[62] *See* rule 10f–3(g).

[63] *See* rule 10f–3(i).

[64] The Commission notes that it may not be necessary for rule 10f–3 to permit the purchase of U.S. government securities because the arrangements among distributors of these securities may not always constitute underwriting or selling syndicates for purposes of section 10(f). *See* Institutional Liquid Assets (pub. avail. Dec. 16, 1981).

of this Release also is reflected in the analysis. A copy of the Initial Regulatory Flexibility Analysis may be obtained by contacting David M. Goldenberg, Securities and Exchange Commission, 450 Fifth Street, N.W., Mail Stop 10–6, Washington, D.C. 20549.

VII. Statutory Authority

The Commission is proposing to amend rule 10f–3 pursuant to the authority set forth in sections 10(f), 31(a) and 38(a) of the Investment Company Act [15 U.S.C. 80a–10(f), 80a–30(a), 80a–37(a)]. New rule 17a-10 is proposed pursuant to the authority set forth in sections 6(c) and 38(a) of the Investment Company Act [15 U.S.C. 80a–6(c), 80a–37(a)].

Text of Proposed Rule and Form Amendments

List of Subjects in 17 CFR Part 270

Investment companies, Reporting and recordkeeping requirements, Securities.

For the reasons set out in the preamble, Title 17, Chapter II of the Code of Federal Regulations is proposed to be amended as follows:

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

The authority citation for Part 270 continues to read, in part, as follows:

Authority: 15 U.S.C. 80a–1 *et seq.*, 80a–37, 80a–39 unless otherwise noted;

* * * * *

Section 270.10f–3 is revised to read as follows:

§ 270.10f–3. Exemption of acquisition of securities during the existence of underwriting syndicate.

Any purchase of securities by a registered investment company prohibited by section 10(f) of the Act shall be exempt from the provisions of such section if the following conditions are met:

(a) The securities to be purchased are:

(1) Part of an issue registered under the Securities Act of 1933 (15 U.S.C. 77a *et seq.*) which is being offered to the public;

(2) Municipal Securities; or

(3) Securities of a Foreign Issuer sold in either an Eligible Foreign Offering or a Foreign Issuer Rule 144A Offering.

(b) The securities are purchased at not more than the public offering price prior to the end of the first full business day after the first date on which the issue is offered to the public; *provided, however,* that:

(1) If the securities are offered for subscription upon exercise of rights, the securities shall be purchased on or before the fourth day preceding the day on which the rights offering terminates; and

(2) If the securities are part of a Foreign Issuer Rule 144A Offering, the securities shall be purchased at not more than the lesser of the public offering price in the concurrent Eligible Foreign Offering or the price paid by each other purchaser of securities in the Foreign Issuer Rule 144A Offering, in each case prior to the end of the first full business day after the first date on which the issue is offered.

(c)(1) If the securities to be purchased are not Municipal Securities, the issuer of such securities shall have been in continuous operation for not less than three years, including the operations of any predecessors; or

(2) If the securities to be purchased are Municipal Securities, the securities shall have received an investment grade rating from at least one NRSRO; *provided,* that if the issuer of the Municipal Securities, or the entity supplying the revenues or other payments from which the issue is to be paid, shall have been in continuous operation for less than three years, including the operation of any predecessors, the securities shall have received one of the three highest ratings from an NRSRO.

(d) The securities are offered pursuant to an underwriting or similar agreement under which the underwriters are committed to purchase all of the securities being offered, except those purchased by others pursuant to a rights offering, if the underwriters purchase any thereof.

(e) The commission, spread or profit received or to be received by the principal underwriters is reasonable and fair compared to the commission, spread or profit received by other such persons in connection with the underwriting of similar securities being sold during a comparable period of time.

(f) The amount of securities of any class of such issue to be purchased by the investment company, or by two or more investment companies having the same investment adviser, shall not exceed 10 percent of the principal amount of the offering of such class, or $1,000,000 in principal amount, whichever is greater, but in no event greater than 15 percent of the principal amount of the offering of such class.

(g) Such investment company does not purchase the securities being offered directly or indirectly from an officer, director, member of an advisory board, investment adviser or employee of such investment company or from a person of which any such officer, director, member of an advisory board, investment adviser or employee is an affiliated person; *provided,* that a purchase from a syndicate manager shall not be deemed to be a purchase from a specific underwriter if:

(1) Such underwriter does not benefit directly or indirectly from the transaction; or

(2) In the case of a purchase of Municipal Securities that is designated as a group sale:

(i) The syndicate manager has determined that group orders for the securities will be given first priority or that only group orders for the securities will be accepted; and

(ii) At the time of the purchase by the investment company, a person referred to in the introductory sentence of paragraph (g) of this section is not obligated to underwrite more than 50 percent of the securities being offered.

(h) For purposes of determining compliance with paragraphs (b)(2) and (g)(2) of this section, an investment company may reasonably rely upon written statements made by a seller of the securities or a member of the underwriting syndicate through which the securities are purchased.

(i) The board of directors, including a majority of the directors of the investment company who are not interested persons with respect thereto:

(1) Has approved procedures, pursuant to which such purchases may be effected for the company, that are reasonably designed to provide that the purchases comply with all the conditions of this section;

(2) Makes and approves such changes as the board deems necessary; and

(3) Determines no less frequently than quarterly that all purchases made during the preceding quarter were effected in compliance with such procedures.

(j) The investment company:

(1) Shall maintain and preserve permanently in an easily accessible place a written copy of the procedures (and any modification thereto) described in paragraph (i)(1) of this section; and

(2) Shall maintain and preserve for a period not less than six years from the end of the fiscal year in which any transactions occurred, the first two years in an easily accessible place, a written record of each such transaction, setting forth from whom the securities were acquired, the identity of the underwriting syndicate's members, the terms of the transaction, and the information or materials upon which the determination described in paragraph (i)(3) of this section was made.

(k) For purposes of this section:

(1) *Eligible Foreign Offering* means a public offering, conducted under the laws of a country other than the United States, of securities issued by a Foreign Issuer, meeting the following conditions:

(i) The offering is subject to regulation by a Foreign Financial Regulatory Authority in such country;

(ii) The laws of such country, or the rules and regulations of such Foreign Financial Regulatory Authority, require the issuer, in connection with the offering, to make information about the issuer and the offering available to the public;

(iii) The securities are offered at a fixed price to all purchasers in the offering (except for any rights to purchase that are required by law to be granted to existing security holders of the issuer); and

(iv) Financial statements, audited in accordance with the accounting standards of such country, for the two years prior to the offering, are made available to the public and prospective purchasers in connection with the offering.

(2) *Foreign Financial Regulatory Authority* has the same meaning as that set forth in section 2(a)(50) of the Act (15 U.S.C. 80a–2(a)(50)).

(3) *Foreign Issuer* means any issuer which is a foreign government, a national of any foreign country, or a corporation or other organization incorporated or organized under the laws of any foreign country.

(4) *Foreign Issuer Rule 144A Offering* means a distribution of securities of a foreign issuer if such securities are offered or sold in the United States solely to persons that the seller and any person acting on behalf of the seller reasonably believe to be qualified institutional buyers, as defined in § 230.144A(a)(1) of this chapter, which securities (''offered securities'') would be eligible for resale to other qualified institutional buyers pursuant to § 230.144A of this chapter, *provided,* that securities of the same class as the offered securities are offered in a concurrent Eligible Foreign Offering.

(5) *Group Order* means an order for securities for the account of all members of a syndicate on a pro rata basis in proportion to their respective participations in the syndicate.

(6) *Group Sale* means a sale resulting from a group order.

(7) *Municipal Securities* has the same meaning as that set forth in section 3(a)(29) of the Securities Exchange Act of 1934 [15 U.S.C. 78c(a)(29)].

(8) *NRSRO* has the same meaning as that set forth in § 270.2a-7(a)(10).

3. By adding § 270.17a–10 to read as follows:

§ 270.17a–10. Exemption of certain group sales.

Any group sale of municipal securities exempted pursuant to § 270.10f-3 shall be exempt from the provisions of section 17(a)(1) of the Act [15 U.S.C. 80a-17(a)(1)].

Dated: March 21, 1996.

By the Commission.

Margaret H. McFarland,

Deputy Secretary.

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