INVESTMENT COMPANY EXAMINATION MANUAL

NON-PUBLIC - FOR STAFF USE ONLY

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INVESTMENT COMPANY EXAMINATION MANUAL

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Preface

The Federal securities laws administered by the Securities and Exchange Commission were designed to protect the interests of investors and of the general public. These laws require that those who deal with the public observe high standards of conduct. The Commission has promulgated rules under the securities laws to assist in carrying out its regulatory and enforcement responsibilities.

The manual was compiled by staff members of the regional offices along with staff members of the Division of Investment Management for the guidance of the staff engaged in investment company examinations. The manual does not cover all possible or probable situations that may arise. It does, however, set forth a wide range of areas and procedures with which the examiner should be familiar.

It must be emphasized that the procedures detailed in the manual should be carried out only where appropriate. If, during an examination, an examiner uncovers matters of particular significance, he/she should report them promptly to his/her immediate supervisor who will then give specific instructions as to further procedures to be followed.

An examiner must have sufficient knowledge, alertness and imagination to recognize "danger signals" and "red flags" which may disclose weak spots in a firm and possible violations of the securities laws. He/she must also possess the ability to follow through and develop all facts necessary to support violations. The manual has been designed to point out many danger areas, close scrutiny of which may be productive of significant information leading to a recommendation for enforcement action or a referral to self-regulatory bodies or state and local governmental agencies.

The manual includes discussions of various Federal securities laws and Commission Regulations as they apply to investment company activities. The discussions are not intended for use as definitive statements of law but are included only to assist the examiner in understanding generally the specific requirements involved. In summary, the manual provides comprehensive and important guidelines to the examiner so that he/she will be alert in recognizing possible violations of the securities laws and rules thereunder, and will be able to uncover and develop pertinent and significant information from an examination of the books and records and operations on which to base a recommendation for further action.

It should be clearly understood that this manual should be used only as a guide. It does not necessarily contain official positions or interpretations of the Commission or any of the Divisions of the Commission.

PART I. BACKGROUND AND GENERAL INSTRUCTIONS

1. DESCRIPTION OF AN INVESTMENT COMPANY

The definition of an investment company for purposes of the Investment Company Act of 1940 ("Act") is contained in Section 3(a) of the Act. Sections 3(b), 3(c), and 6(c) describe specific exceptions from the definition or exemptions from the provisions of the Act.

An important distinction between an investment company and other forms of enterprise is that an investment company is primarily engaged in, or proposes to engage primarily in, the business of investing, reinvesting, or trading in securities, other than through controlled subsidiaries.

When companies are engaged in the business of investing, trading, or holding securities, but, in addition, are engaged in other activities, a detailed analysis is required to determine whether or not such company meets the definition of an investment company. 1/ The purpose of such an analysis is to determine whether or not the primary activities of the company are those of an investment company. Many factors must be considered but, in most cases, a major determinant is whether or not a substantial portion of a company's assets consist of securities.

In making such an analysis, it is important to note the distinctions between the provisions of the applicable statutory definitions. The most important are contained in Sections 3(a)(1) and 3(a)(3) as modified by Sections 3(b)(1) and 3(b)(2). 2/

The pertinent provisions of Section 3(a) are as folows:

> Sec. 3. (a) When used in this title "investment company" means any issuer which --
>
> (1) is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading in securities; (underlining added for emphasis) . . .

1/ See Appendix I-A, "The Inadvertent Investment Company" for details as to the applications of Section 3 in such cases.

2/ Section 3(a)(2) defines a face amount certificate company to be an investment company. Inasmuch as there are only 5 active face amount certificate companies registered, we are devoting relatively little discussion in this manual to such companies.

> (3) is engaged or proposed to engage in the business of investing, reinvesting, owning, holding, or trading in securities, and owns or proposes to acquire investment securities having a value exceeding 40 per centum of the value of such issuer's total assets (exclusive of Government securities and cash items) on an unconsolidated basis. (underlining added for emphasis)
>
> As used in this section "investment securities" includes all securities except (A) Government securities, (B) securities issued by employees' securities companies, and (C) securities issued by majority-owned subsidiaries of the owner which are not investment companies.

Sec. 3(a)(1) describes the orthodox investment company. To meet this definition, a company's primary activity must be in the business of investing, reinvesting, or trading in securities. Note that the definition uses the term "securities," which has a rather broad meaning and is defined in Section 2(a)(36) as follows:

> "Security" means any not, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, or, in general, any interest or instrument commonly known as a "security," or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

The term encompasses corporate stocks and bonds, certificates of deposit and other short-term investments, promissory notes, guarantees of indebtedness, investment contracts, voting trust certificates, and many other forms of evidences of interest, some of which need not even be in writing.

On the other hand, Section 3(a)(3) states that if forty per cent of the value of a company's total assets consist of "investment securities" as defined, the company may be an investment company. The portfolio need not be active. The term "investment securities" is used here and means all securities except Government securities, securities issued by employees' securities companies and securities issued by majority-owned subsidiaries of the owner that are not investmentcompanies. Note the use of the words "holding" and "owning" which are not used in 3(a)(1).

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> "Security" means any not, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, or, in general, any interest or instrument commonly known as a "security," or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

The term encompasses corporate stocks and bonds, certificates of deposit and other short-term investments, promissory notes, guarantees of indebtedness, investment contracts, voting trust certificates, and many other forms of evidences of interest, some of which need not even be in writing.

On the other hand, Section 3(a)(3) states that if forty per cent of the value of a company's total assets consist of "investment securities" as defined, the company may be an investment company. The portfolio need not be active. The term "investment securities" is used here and means all securities except Government securities, securities issued by employees' securities companies and securities issued by majority-owned subsidiaries of the owner that are not investmentcompanies. Note the use of the words "holding" and "owning" which are not used in 3(a)(1).

Section 3(b)(1) is designed to exclude those companies which have a substantial portion of their assets in securities but which are primarily engaged in other activities. Section 3(b)(2) has similar purposes but requires a Commission order. Section 3(b)(1) reads as follows:

> Notwithstanding paragraph (3) of subsection (a), none of the following persons is an investment company within the meaning of this title:
>
> (1) Any issuer primarily engaged, directly or through a wholly owned subsidiary or subsidiaries, in a business or businesses other than that of investing, reinvesting, owning, holding, or trading in securites. . . .

The most important factor in the determination of whether or not a company is primarily engaged in a business other than that of an investment company is the ratio of securities to total assets. Another important factor may be the ratio of security income to operating revenue.

In making a financial analysis for the purpose of determining whether or not a company is an investment company as defined, the term "value" as it appears in various parts of Section 3 should be given the meaning intended by Section 2(a)(41) which reads in part as follows:

> "Value," with respect to assets of registered investment companies . . . means --
>
> (A) as used in Sections 3, 5, and 12 of this title, (i) with respect to securities owned at the end of the last preceding fiscal quarter for which market quotations are readily available, the market value at the end of such quarter; (ii) with respect to other securities and assets owned at the end of the last preceding fiscal quarter, fair value at the end of such quarter, as determined in good faith by the board of directors, and (iii) with respect to securities and other assets acquired after the end of the last preceding fiscal quarter, the cost thereof. . . .

2. CHARACTERISTICS OF VARIOUS TYPES OF INVESTMENT COMPANIES

A. Classification and Subclassification of Investment Companies

The Classification and subclassification of investment companies are specifically set forth in Sections 4 and 5 of the Act which read as follows:

> Classification of Investment Companies
>
> Sec. 4. For the purposes of this title, investment companies are divided into three principal classes, defined as follows:
>
> (1) "Face-amount certificate company" means an investment company which is engaged or proposes to engage in the business of issuing face-amount certificates of the installment type, or which has been engaged in such business and has any such certificate outstanding.
>
> (2) "Unit investment trust" means an investment company which (A) is organized under a trust indenture, contract of custodianship or agency, or similar instrument, (B) does not have a board of directors, and (C) issues only redeemable securities, each of which represents an undivided interest in a unit of specified securities; but does not include a voting trust.
>
> (3) "Management company" means any investment company other than face-amount certificate company or a unit investment trust.
>
> Subclassification of Management Companies
>
> Sec. 5(a). For the purpose of this title, management companies are divided into open-end and close-end companies, defined as follows:
>
> (1) "Open-end company" means a management company which is offering for sale or has outstanding any redeemable security of which it is the issuer.
>
> (2) "Closed-end company" means any management company other than open-end company.

Sec. 5(b). Management companies are further divided into diversified companies and non-diversified companies, defined as follows:

(1) "Diversfied company" means a management company which meets the following requirements: At least 75 per centum of the value of its total assets is represented by cash and cash items (including receivables), Government securities, securities of other investment companies, and other securities for the purposes of this calculation limited in respect of any one issuer to an amount not greater in value than 5 per centum of the value of the total assets of such management company and to not more than 10 per centum of the outstanding voting securities of such issuer.

(2) "Non-diversified company" means any management company other than a diversified company.

Sec. 5(c). A registered diversified company which at the time of its qualification as such meets the requirements of paragraph (1) and and subsection (b) shall not lose its status as a diversified company because of any subsequent discrepancy between the value of its various investments and the requirements of said paragraph, so long as any such discrepancy existing immediately after its acquisition of any security or other property is neither wholly nor partly the result of such acquisition.

B. Open-End Companies (Mutual Funds)

Open-end investment companies or mutual funds are management companies which are offering or have outstanding redeemable securities. Thus, shareholders of an open-end investment company have the right to obtain from the company, upon proper tender of their shares, their proportionate share of the company's net assets or the cash equivalent. A management company is one which does not have a fixed portfolio and is not issuing or has not issued face-amount certificates. Shares of open-end investment companies can be purchased by investors directly from the funds or its representative, or from retailing dealers who in turn purchase the shares from principal underwriters for the respective investment companies. Shares can also be purchased directly from the principal underwriter. The investment companies are normally formed, promoted, underwritten, and managed by external organizations that are separately owned and operated. The controlling entity is usually the investment adviser (sometimes designated as the management company). In return for its services, the investment adviser receives a fee, which is usually a specific percentage of the investment company's net asset value.

C. Load and No-Load Funds

Investment companies which impose a sales charge or load for the purchase of their shares are referred to as "load" funds. Other funds which do not impose a sales load on the purchase of their shares are called "no-load" funds. Broker dealers, who sell shares of load funds, can receive a portion of the sales load in the form of a concession. Because no-load funds do not afford an intermediary the opportunity to participate in a sales charge, no-load funds are generally sold to the public without the intermediary service of retailing dealers. The most common method for promoting and selling the shares of these companies is through newspaper advertisements.

D. Closed-End Companies

Closed-end investment companies are management investment companies which do not have outstanding and are not publicly offering, redeemable securities. Shares of thse companies are traded in the same way as shares of operating or industrial concerns. Some are listed on stock exchanges and others are traded on the over-the-counter market. Since these shares are not redeemable; the price at which the shares are traded does not always bear a relationship to their net asset value per share. Most of the time, these shares trade at a discount or below the current net asset value.

E. Small Business Investment Companies

Some closed-end investment companies are licensed under the Small Business Investment Act of 1958 which is administered by the Small Business Administration. The function of these companies is mainly to furnish capital to small businesses. An essential feature of small business investment companies is that they can borrow money from the Small Business Administration, usually at favorable rates, which in turn is loaned to small businesses at relatively high rates. Many small business investment companies play an active role in the management and affairs of the companies whose securities they hold. Significantly, their investment portfolios consist mainly of high risk securities which are not readily marketable and usually are "restricted" as to resale. 1/

Because of the fact that many of the security holdings of small business investment companies represent affiliated interests therein, any transaction involving the fund and its "portfolio" affiliate must comply with Section 17(a) of the Act and Rule 17a-6 thereunder. For example, if investment company A owned 5 per centum or more of the outstanding voting securities of Company B, B would be designated a portfolio affiliate of A. If B wanted to borrow additional monies from A by issuing a subordinated debenture, such transaction would necessitate an application for exemptive relief unless it was specifically exempted under Rule 17a-6 of the Act.

1/ See Appendix I-G-1, Investment Company Act Release No. 5847 - Restricted Securities.

F. Variable Annuities

A variable annuity is an annuity contract developed by the life insurance industry. During the pay-in period, fixed monthly payments, after certain charges, are invested in a portfolio of securities. 1/ The risk of investment is borne by the annuitant and not the insurance company. After the pay-in period, the purchaser receives a variable monthly annuity for the remainder of his life or other elected pay-out period. The amount of this monthly annuity payment is dependent on the increase or decrease in value of the amount invested in the portfolio of securities. Historically, insurance companies have been subject to regulation by various state insurance departments. However, since the variable annuitant bears the investment risk, the Supreme Court, in 1959, held that insurance companies issuing variable annuities were investment companies and thus also subject to Federal securities regulations. SEC v. Variable Annuity Life Insurance Company, 359 U.S. 65 (1959). 2/

G. Unit Investment Trusts

Unit investment trusts are investment companies issuing or having issued redeemable undivided interests in units of specified securities. A fixed trust issues shares representing units of a fixed portfolio of securities. A second type of unit investment trust has, as its assets, shares of one specific company, usually shares issued by an open-end investment company. Unit trusts are organized under a trust indenture, custodian contract or similar instrument, and do not have a board of directors.

H. Face-Amount Certificate Companies

Face-amount certificate companies issue, propose to issue, or have outstanding debt certificates of the installment type, obligating the companies to pay, at a future specified date, fixed sums (the face-amount) to investors. The rates of return on the certificates are low and usually predetermined. They may be purchased by single payments or a series of installment payments. The assets of these companies usually include a diversified portfolio of marketable investment securities.

Usually, these companies are initially capitalized through the issue of a limited amount of equity securities such as common stock. They then issue debt securities to the general public in the form of face amount certificates which pay a stated (usually low) rate of interest. The proceeds from the sale of the certificates are then invested in a portfolio of securities. The major portion of earnings from the investments, after payment of interest on the certificates, are eventually realized by the company's equity investors. Certificate holders sometime participate in these earnings, usually in a small way, through various pre-designated arrangements whereby a specified portion of earnings during a financially successful period is distributed to them.

1/ Some Contracts are sold as single payment plans with the payout period either being deferred or commencing immediately.

2/ See Appendix II-B, Variable Annuity Inspection Outline.

3. APPLICABLE STATUTES AND REGULATIONS

A. Investment Company Act of 1940

The Act and the Rules and Regulations thereunder govern most aspects of investment company activities. The Act is a highly detailed statute designed to protect the interests of investors and the public. In addition to a requirement that such companies register with the Commission, the law requires disclosure of their financial condition and investment policies to afford investors full and complete information about their activities; prohibits, among other things, such companies from changing the nature of their business or their investment policies without the approval of the stockholders; bars persons guilty of security frauds from serving as officers, directors or employees; prevents underwriters, investment bankers or brokers from constituting more than a minority of the directors, of such companies; requires management contracts (and material changes therein) to be submitted to security holders for their approval; prohibits transactions between such companies and their directors, officers, or affiliated companies or persons, except on approval by the Commission as being fair and involving no overreaching; forbids the issuance of senior securities by such companies except under specified conditions and upon specified terms; and prohibits pyramiding of such companies and crossownership of their securities.

Other provisions relate to sales and repurchases of securities issued by investment companies, exchange offers, and other activities of investment companies, including special provisions for periodic payment plans and face-amount certificate companies.

B. Investment Advisers Act of 1940

The Investment Advisers Act of 1940 ("Advisers Act"), enacted as a companion to the Act, regulates those who receive compensation for advising others with respect to investments in securities or are in the business of issuing analyses or reports concerning securities. Investment advisers to investment companies are subject to its provisions. The Advisers Act requires registration with the Commission, prohibits fraudulent practices, and empowers the Commission to discipline violators of the statute and of its rules.

C. The Securities Act of 1933

The Securities Act of 1933("Securities Act"), the first of the Federal securities statutes, is essentially a disclosure statute. Its primary effect is on the initial distribution of securities. Its chief purpose is to provide purchasers of securities being offered by issuers and others, with information material to informed investment decisions. The Act requires registration of securities offered to the public. After the offering is completed, the Act does not require that the registration statement be continuously amended to reflect current conditions.

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C. The Securities Act of 1933

The Securities Act of 1933("Securities Act"), the first of the Federal securities statutes, is essentially a disclosure statute. Its primary effect is on the initial distribution of securities. Its chief purpose is to provide purchasers of securities being offered by issuers and others, with information material to informed investment decisions. The Act requires registration of securities offered to the public. After the offering is completed, the Act does not require that the registration statement be continuously amended to reflect current conditions.

Since closed-end investment companies usually do not continuously issue securities, they may not come into contact with the Securities Act after their initial public offering, unless they decide to raise additional capital by issuing new shares to the public or unless controlling persons of those companies wish to distribute some or all of their personal holdings to the public. Under certain circumstances, closed-end investment companies may also be affected by the Securities Act in connection with their transactions in portfolio securities which may be restricted as to resale. 1/

Open-end investment companies, which continuously offer their shares to the public (mutual funds), are in continuous contact with the Securities Act. They file a Securities Act registration statement on the appropriate form and are obligated to currently maintain the information required to be reported, at least with respect to all material items. 2/ They do this by filing amendments to their registration statement. Amendments filed prior to the date that a registration becomes effective are numbered consecutively with the designation "Pre-Effective Amendment No. __". Those amendments filed after a registration statement becomes effective are also consecutively numbered but are designated as "Post-Effective Amendments". The financial statements that appear in the prospectus, which is an important part of the registration, are required by Section 10(a)(3) of the Securities Act to be as of a date not more than sixteen months prior to their use, if a prospectus is used more than nine months after the effective date of the registration statement. Consequently, registration statements of open-end investment companies which are offering shares are amended at least once annually, usually within four months after the end of their fiscal year.

D. Securities Exchange Act of 1934

The Securities Exchange Act of 1934 ("Exchange Act") supplemented the Securities Act by establishing a system of controls over both the exchange and the over-the-counter trading markets for securities. Among the provisions that bear most directly on the investment company industry are those which establish administrative mechanisms in connection with the sale of investment company shares to protect the public from dishonest or irresponsible dealers.

The Exchange Act requires the registration of most brokers and dealers with the Commission and empowers the Commission to exclude persons and firms subject to specified disqualifications from most segments of the securities business and to take other remedial action against them.

The Exchange Act also sets forth, pursuant to Section 14 and the rules thereunder, certain important requirements for the solicitation of proxies in

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1/ See Appendix I-G-1, Investment Company Act Release No. 5847 - Restricted Securities.

2/ See Part I, Section 4 of this manual - Investment Company Filings with the Commission.

connection with shareholder meetings including shareholder meetings held by investment companies.

4. INVESTMENT COMPANY FILINGS WITH THE COMMISSION

Registered investment companies are required to file a number of reports and other materials with the Commission. Copies of such forms and reports can be found in CCH. Included among these forms are the following:

A. Form N-8A Notification of Registration

Form N-8A is the initial Investment Company Act registration form filed by investment companies. Upon receipt of the completed form by the Commission, a company becomes a registered investment company pursuant to Section 8(a) of the Act. The form is relatively short but is required to be followed by a longer, more detailed registration statement.

B. Forms N-1 and N-2

Management companies shall file a registration statement on Form N-1 or N-2 within three months after the filing of notification of registration under Section 8(a) of the Act. Provided, that if the fiscal year of the company ends within the 3-month period, its registration statement may be filed within 3 months after the end of such fiscal year.

Form N-1 shall be used as the registration statement to be filed, pursuant to Section 8(b) of the Act, by open-end management investment companies other than companies which issue periodic payment plan certificates or which are sponsors or depositors of companies issuing such certificates. This form shall also be used for registration under the Securities Act of of the securities offered by open-end management investment companies.

Form N-2 shall be used as the registration statement to be filed, pursuant to Section 8(b) of the Act, by closed-end management investment companies other than companies which issue periodic payment plan certificates or which are sponsors or depositors of companies issuing such certificates. This form also shall be used for the registration under the Securities Act of the securities offered by closed-end management investment companies.

Forms N-1 and N-2 have replaced Forms N-8B-1, and S-4 and S-5. 1/ Such replacement has lessened the burden of reporting requirements for management

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1/ See Appendix I-B-3, Investment Company Act Release No. 10378, Integrated Reporting System for Investment Companies.

companies. However, the annual update procedure is applicable to all management companies, including closed-end. Thus, reasonably current information concerning the operations of all management investment companies is on file with the Commission and available for public inspection.

C. Forms N-8B-2, N-8B-3 and N-8B-4

Depending on whether an investment company is a unit investment trust, unincorporated management investment company or a face amount certificate company, such companies will also have to file a registration statement within 3 months after the filing of a notification under Section 8(a) of thu Act. Such companies may file their registration statements within 3 months after the end of the fiscal year if their fiscal year ends within 3 months after the filing of the notification of registration. The forms vary somewhat according to the type of investment company as follows:

1. Form N-8B-2: Registration Statement of Unit Investment Trusts which are Currently Issuing Securities.

2. Form N-8B-3: Registration Statement of Unincorporated Management Investment Companies Currently Issuing Periodic Plan Certificates.

3. Form N-8B-4: Registration Statement of Face Amount Certificate Companies.

D. Form N-5

Form N-5 is used for both Securities Act and Investment Company Act registration requirements by investment companies which are licensed by the Small Business Administration as Small Business Investment Companies.

E. Form S-6

Form S-6 is used for both Securities Act and Investment Company Act registration requirements for unit investment trusts.

F. Form N-1R

Form N-1R, annual report of registered management investment companies, is required to be filed within 120 days after the close of the company's fiscal year end. Form N-1R has been drafted as a totally computerized form (except for exhibits which must be filed if the form items are responded

to in a certain manner). A system for detecting possible violations via the computer is in place and should serve as a useful tool to the inspection process. Copies of Form N-1R are available on microfiche and can be ordered via the computer terminal in your office. See page 18 for further information relating to ordering of Commission files and reports.

G. Form N-1Q

Form N-1Q is required to be filed with the Commission quarterly by all registered management investment companies. The form requires information as to changes in a number of areas but principally changes in the purchase and sale of portfolio securities.

H. Reports to Shareholders

Detailed financial reports are required to be transmitted to shareholders of registered investment companies at least semi-annually by Section 30(d) of the Act. Copies of these are required to be filed with the Commission.

I. Proxy Statements

A proxy is a power of attorney granted by shareholders for the specific purpose of authorizing another (usually management) to vote their stock. Controlling persons of investment companies regularly solicit shareholder proxies prior to shareholder meetings. Such solicitations must comply with Section 20(a) of the Act and Section 14 of the Exchange Act and the respective rules thereunder. Among other things, persons soliciting proxies are required to make adequate disclosures as to matters to be voted upon at the shareholder meetings. These solicitations and disclosures appear in a proxy statement which is sent to investment company shareholders. The preliminary and definitive proxy materials are required to be filed with the Commission.

J. Form N-8F

This form shall be used as the application for an order of the Commission pursuant to Section 8(f) of the Act in cases where the applicant (a) has distributed substantially all of its assets to its shareholders, and has effected, or is in the process of effecting, a winding-up of its affairs; or (b) has never made a public offering of its securities, has not more than one hundred securityholders for the purposes of Section 3(c)(1) of the Act and the rules thereunder, and does not propose to make a public offering or engage in business of any kind; or (c) has (1) sold substantially all of its assets to another registered investment company, or (2) merged into or consolidated with another registered investment company.

K. Sales Literature and Advertising

The Securities Act severely restricts the type of advertising an issuer or its underwriter can use in offering the issuer's securities to investors. Virtually all open-end investment companies and unit trusts are continuously offering their shares to the public and are, therefore, subject to these restrictions. Most of the restrictions apply only until the investor receives a statutory prospectus. 1/ Their purpose is to make the statutory prospectus the primary selling document relied upon by investors.

(1) Review of Sales Literature and Advertising Materials

Registered open-end investment companies, unit investment trusts and face amount certificate companies and their underwriters must file their advertising materials with the Commission pursuant to Section 24(b) of the Act. The staff does not formally review these filings nor does it normally give interpretive opinions on the appropriateness of sales literature. 2/ Underwriters that are members of the National Association of Securities Dealers (NASD) must also submit the investment company advertising they use to the NASD for review. Neither of these reviewing processes, however, are meant to substitute a thorough independent review of all advertising materials during the course of an inspection.

The examiner should request all advertising materials used during the period under examination and determine how each of the materials was disseminated. Advertisements that reached persons who had not previously or simultaneously received a statutory prospectus should be reviewed for compliance with the summary prospectus requirements of Rule 434d, the tombstone advertisement requirements of Rule 134 or the generic advertisements requirements of Rule 135a. These and all other advertisements should then be reviewed for materially false or misleading statements using Rule 156 of the Securities Act as one of the guidelines in making that review.

(2) Inspection of Advertising Materials

Advertising representations may be the only information the investor has to consider before making the decision whether or not to invest. Therefore a careful review of advertising material during an inspection is crucial to the fulfillment of the Commission's responsibility to investors.

1/ Generic advertisements are not deemed to be an offer of a security for sale for purposes of Section 5 of the Securities Act.

2/ Investment Company Act Release No. 10621 (March 8, 1979). This policy does not apply to staff review of statutory prospectuses.

(3) Compliance Reviews Prior to the Inspection

The initial prospectus of every investment company is reviewed by the staff before the company could commence sale of its shares to the public. Registered open-end investment companies, unit investment trusts and face amount certificate companies and their underwriters are required by Section 24(b) of the Act to file their advertising materials, other than the prospectus, with the Commission. The staff periodically spot checks a small sample of these filings but for the purpose of your inspection, you should assume the material has not been reviewed. Members of the National Association of Securities Dealers (NASD) also are required to have their material cleared by the NASD prior to distribution to the public. However, the primary review of advertising material by the usually occurs on-site during an inspection.

(4) Review During an Inspection

The examiner should request all advertising materials used since the last inspection and find out how each copies was disseminated to the public. The review of representations made on behalf of an investment company initially requires three determinations: are the anti-fraud satutes violated, do representations comply with applicable special standards, and is the material being filed with the Commission.

1) Do the representations made comply with the appropriate anti-fraud statutory sections of the Securities Act and the Exchange Act which are applicable to investment company promotional statements?

Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder prohibit the use of any type of advertising in the offer or sale of securities which is materially false or misleading. Rule 156, an interpretive rule under the Securities Act, identifies areas of investment company advertising that traditionally have been susceptible to misleading statements. Rule 156 was adopted after the Commission withdrew its Statement of Policy which had served since 1950 as guidelines to investment companies on what the Commission regarded as potentially misleading advertising representations.

Every type of investment company advertising is subject to one or both of these anti-fraud statutes. This includes the prospectus, oral statements made in person, on TV or radio, ads appearing in newspapers or magazines and other written material received by a potential investor. How do you know fraud when you see it? If, for example, a fund touting a conservative portfolio was found to be heavily invested in speculative penny stocks that would be fraud. Basically, to discover fraud you should be aware of the objectives and policies of the fund and characteristics of the financial markets and use a good measure of common sense.

2) Is there compliance with the special standards found in Rules 434d, 134 or 135a of the Securities Act which may be applicable to a particular piece of sales literature?

This will depend on whether or not the advertising reaches a member of the public before he or she has received a prospectus. The prospectus is intended to be the primary selling document used to promote the sale of investment company securities. Therefore, materials received by the public before they receive a prospectus are subject to special restrictions. Such material can be divided into three general categories: an omitting prospectus, a tombstone advertisement and a generic advertisement.

a. An Omitting Prospectus, defined in Rule 434d under the Securities Act, is an advertisement which (1) appears in a bona fide newspaper or magazine or on radio or television, (2) contains only information found in the current statutory prospectus (although precise tracking of the language used in the Section 10(a) prospectus is not required) and (3) states from whom a more complete prospectus may be obtained. Thus, for example, yield statistics may appear in this type of ad if identical information is found in the prospectus and the ad is not otherwise misleading. Rule 434d also permits an omitting prospectus to be used before a company's registration statement becomes effective if it contains specified disclosure on this pre-effective status. Unlike other forms of advertising, representations permitted by Rule 434d are deemed to be a prospectus, and therefore, are subject to liability under Section 10(b) of the Securities Act.

b. A Tombstone Advertisement is defined in Rule 134 of the Securities Act and is designed to give investors fundamental information about a particular investment company which will assist a potential investor in deciding whether or not to request a prospectus. These ads typically are the type of investment company advertisements found in the Wall Street Journal. Because a tombstone advertisement is not included within the definition of a prospectus under Section 2(10) of the Securities Act and therefore is not subject to the statutory liability under Section 10(b) of the Securities Act, the rule specifically restricts what information can be included in this kind of advertisement. Rule 134 permits a brief description of such things as the name of the issuer, the offering and how a statutory prospectus on the fund may be obtained. Read the rule for

specific categories of information which may be presented in this type of ad. Tombstone advertisements can be placed in mass advertising mediums (newspapers, magazines, television, radio) or be sent directly to potential investors.

c. A Generic Advertisement is subject to the requirements of Rule 135a of the Securities Act. An example is an industry ad discussing investment companies in general and no one company in particular. Like a tombstone advertisement, it is not by definition a prospectus and is restricted by rule on what information it may contain. A generic advertisement may contain general information about investment companies and invite investor inquiries for further information about particular categories or investment companies.

3) Is the appropriate material being filed with the Commission in accordance with Section 24(b) of the Act?

Open-end investment companies, unit investment trusts and face amount certificate companies who are registered with the Commission and their underwriter must file all advertising material within 10 days after it is used. Omitting prospectuses under Rule 434d of the Securities Act are excluded from this filing requirement because the Commission receives them under parallel prospectus filing requirements.

5. PURPOSE AND FUNCTIONS OF COMPLIANCE EXAMINATIONS

Compliance examinations (or inspections) of investment companies are conducted primarily to ascertain whether or not practices and procedures are being conducted by the companies in compliance with the various Federal securities laws. Examinations should not be confused with audits, which are conducted primarily for the purpose of certifying that a company's financial statements present fairly the financial condition, results of operations, and changes in net assets of the company. Although there is some overlapping as to procedures and objectives, the functions and scope of audits by independent accountants and compliance examinations are basically different.

1/ See Appendix I-B-4, Investment Company Act Release No. 10447, Review accorded routine post-effective amendments and proxies of investment companies.

The use of test-checks, scanning, interviews, actual observation of operational procedures, and the extraction and analysis of information from books and records are among the methods used during examinations to seek indications of possible problem areas being encountered by investment companies. Certain matters may warrant complete coverage and others may require only a perfunctory review. Although a reasonable amount of standardization is desirable, the conduct of an examination depends in large measure on the exercise of initiative and sound judgment on the part of the examiners.

There are two primary types of examinations -- "cause" and "routine." A cause examination results from the receipt of information that an investment company may be engaging in practices in violation of the Federal securities laws or may be experiencing financial or other difficulties. Such examinations normally take precedence over routine examinations. The source of such information may be a compliant from a fund shareholder, the general public, the industry or a referral from the main office of the Commission. The cause examination may be directed at certain limited areas of critical interest, such as portfolio trading, financial condition, transactions with affiliated persons, books and records, custody arrangements, etc. All examinations which are not for cause fall into the "routine" category.

6. PREPARATION AND PLANNING - SUGGESTED PROCEDURES

A. Obtain and Review Files

Prior to the examination, all available Commission reports and files relating to the investment company and affiliated persons should be obtained and reviewed. Files pertaining to affiliated investment advisers and broker-dealers (including the principal underwriter) should be available at the Regional Office. The registration and correspondence files of the company should be requested directly from the Commission's Office of Reports and Information Services. Be sure to indicate the Company's "811 dash" designation and "2 dash" numbers on the request form.

The "811 dash" designation is used in reference to an investment company's filings under the Act. These files include the company's registration statement under the Act, proxy materials, reports to shareholders, N-1R reports, and N-1Q reports.

The "2 dash" designation is used in reference to an investment company's filings under the Securities Act. These files contain the company's Securities Act registration statements including the prospectus. It is especially important that the current prospectus be read thoroughly prior to the commencement of the examination and any unusual aspects of the Fund's operations be noted for further inquiry during the examination.

There are usually three sub-categories of filings under both the "811 dash" designation and the "2 dash" designation. These are sub-designated as

the "dash 1", "dash 2" and "dash 3" files. The "dash 1" files contain registration statements and amendments thereto, the "dash 2" files contain required reports and other filings, and the "dash 3" files contain correspondence.

Hardcopy filings are usually retained in the Central Records Section for three years and then transferred to the Federal Records Center. Such filings are normally available to only the staff at the home office. Delivery of these files within the home office of the Commission normally requires from 24-72 hours. Experience dictates, however, that an examiner should make a request for files as soon as practicable.

A micrographics program has been inaugurated by the Commission which will eventually encompass the majority of the filings made with the Commission. Many of the forms and reports currently filed under the Act are available in microfiche. A program has been implemented whereby files and reports on microfiche may be requested via the computer terminal in your office. If you are unable to request the desired reports and records by the computer, it is suggested that you contact the Office of Reports and Information Services (Central Records or Microfiche) for further assistance. For a listing of the various forms and reports filed under the Investment Company Act, see Appendix I-B-7.

If during the review of an investment company's filings, it is noted that a company is not filing required reports or is chronically late in filing such reports the examiners' attention should be directed to determining the reasons therefor.

From the Computer terminal, it can be determined whether the investment company has received or has pending any applications for exemption from the Act. Such applications are categorized with an "812" prefix. An examiner should review exemptive orders and ascertain compliance therewith. If an application is still pending, it is suggested that the examiner call the Division to determine the current status of such application.

Finally, the examiner should review the report of any previous examination of the investment company to be inspected and note the past deficiencies. Any past deficiencies which have not been corrected should be so indicated in the examiner's report.

B. Prepare Block Diagram of Investment Company Complex

In most cases, the investment company scheduled for examination is part of a "complex" containing an investment adviser, a principal underwriter, a unit investment trust, and other investment companies. The investment company may also be associated with affiliated holding companies and/or broker-dealers. A block diagram of the complex should be prepared before the examination commences, using the data available in the Commission's files and reports.

C. Prepare Draft Copy of Facing Pages to the Examination Report

The facing pages to the examination report 1/ should be prepared at this time to the extent that information is available. This gives the examiners a number of items of basic information in readily available form. This information includes the names and addresses of the investment company, its investment adviser, principal underwriter, and custodian; the classification and sub-classification of the investment company; and names of officers and directors and their affiliations.

D. Assign Responsibilities

When an investment company examination is to be conducted by two or more examiners, one examiner should be designated as the leader. The "examiner in charge" should be responsible for work assignments, following the Examination Outline, and preparing the examination report. In order to do this he should hold, review (and understand) all work papers; and be kept informed as to all phases of the inspection. He should also be present at all of the important discussions held concerning the examination.

At this time, areas to be covered by each examiner should be assigned by the examiner in charge. It is suggested that the assignments be made to conform to the categories set forth in the "Investment Company Examination Outline" which sets forth the ares to be reviewed during examinations. The items in the Outline are grouped into four categories as follows: 2/

1. Financial Analysis

2. Investment Activities

3. Management Functions

4. Sales and Liquidations of Investment Company's Shares

It cannot be emphasized too strongly that an investment company examination is a team effort. Attempts at "grandstanding" or other efforts by examiners at trying to achieve individual recognition by not fully consulting the examiner in charge of all material developments during the examination should be firmly discouraged. Also, an examiner is expected to have the ability to work well with others. A great deal of cooperation is involved in performing the various tasks required to be accomplished during the examination, and in the exchange of information or materials which may have a bearing on more than one area of review.

1/ See Appendix I-D, Facing Pages for Inspection Reports.

2/ See Appendix I-E, Investment Company Examination Outline.

However, adhering too strictly to a structured examination approach may impact negatively on the creativity of examiners. If an examiner feels that a certain matter warrants further review and analysis, the examiner in charge should be apprised. This will enable the examiner in charge to consider the importance and potential consequences of such efforts, and allow a reassignment of tasks to pursue such matters.

E. Submit Notification of Commencement to Division of Investment Management

At, or just prior to, the start of an examination submit a "Notification of Commencement" to the Division of Investment Management using Form L-2117. 1/

F. Prepare a List of Information and Materials to be Requested

A list should be prepared of information and materials which should be requested to be furnished by the investment company during the examination. The request should be made as soon as possible after the start of the examination. All items should be requested through the principal executive officer (or his designated representative) of the investment company, including that information required to be furnished by the Custodian or Transfer Agent. Listed below is a suggested list of items and materials to be requested.

Suggested List of Items to be Requested of Investment Companies Being Examined:

1. Copies of:

   A. Current prospectus

   B. Latest proxy statements

   C. Latest annual report to shareholders

   D. Latest semi-annual report to shareholders

   E. All sales literature and advertising materials

   F. Advisory contract, distributor's contract, custodian agreements and any other pertinent agreements and contracts

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1/ See Appendix I-C, Form L-2117, Notification of Commencement of Investment Company Examination.

G. Most recent month-end pricing sheet (including list of securities and valuations)

H. Current and complete fidelity bond, and related agreements

I. "Blue-back" or auditors report to management of the internal operations and control

J. Bank statements and reconciliations for both cash and securities as of most recent month-end

2. Lists of:

A. Directors, officers, employees of investment company. With regard to officers and directors, list their functions with respect to any audit, investment or other fund committees.

B. Directors, officers, and shareholders of investment adviser (and parent companies)

C. Directors, officers, and shareholders of principal underwriter (and parent companies)

D. Employees of investment adviser and principal underwriter (by number and type)

E. States where the fund is authorized to sell it shares

3. From Custodian:

A. List of assets held as of most recent month-end

4. From Transfer Agent:

As of most recent month-end

A. Number of shares outstanding

B. Number of shareholders of record

C. List of shareholders owning 1% or more of Company's stock.

5. Access to:

A. Books and records

B. Directors minutes of the fund(s) and investment adviser

C. Committee minutes

D. Code of Ethics and procedures, and compliance manual (if any)

E. Guidelines to valuation of restricted securities (if any)

F. Xerox facilities (see section 31(b) regarding registrant's requirement to furnish records and conditions thereon)

G. Pricing sheet and net asset value computation as of most recent audit date or date selected

7. GENERAL NOTES ON EXAMINATION PROCEDURES

A. Commencing the Examination

Upon entering the premises of an investment company unannounced, the "examiner in charge" should identify himself and ask to see the principal executive officer. After introducing himself and the other members of the team to the principal executive officer (or his designated representative), the "examiner in charge" should submit the list of requested items. At the same time, the examiners, as required by the Privacy Act of 1974, should inform each individual, beginning with the principal executive, whom they ask to supply information of the authority for soliciting such information and whether disclosure of such information is mandatory or voluntary, the principal uses of the information, the routine uses of the information and the effects of not providing the requested information. Form SEC 1661 titled "Notice Pursuant to the Privacy Act of 1974 For An Inspection of Persons and Entities Regulated by the Commission . . ." and Form SEC 1660 titled "Routine Uses of Information Furnished to the Securities and Exchange Commission" should be given to persons supplying requested information to satisfy the notification requirements of the Privacy Act. It is suggested that acknowledgment of receipt of Forms SEC 1661 and 1660 be obtained from individuals supplying information during an examination and that correspondence and conversations with those individuals subsequent to the examination make reference to the notification. Good judgment is necessary in soliciting information and giving the Privacy Act Notice bearing in mind that the Privacy Act is designed to protect individuals.

Having given the principal executive a Privacy Act Notice and the list of requested items, the examination can continue.

The examiner in charge then should ask that officials of the principal underwriter, investment adviser, custodian, plan agent, transfer agent, and service agent be made aware of the inspection, and that key officials and pertinent records be made available to the examiners.

The principal executive officer (or his designated representative) should be asked to provide a tour/review of the fund's operations. This would include introducing the examiners to the people who are responsible for the key operations of the fund along with an overview or brief description of their respective duties. This tour will serve as a basis for understanding the registrant's flow of operations and enable the examiners to pinpoint those executives who have the responsibility for and are directly involved in the major aspects of the operations:

1. Investment decisions.

2. Execution of transactions in portfolio securities.

3. Calculation of net asset value (accounting).

4. Processing of sales and redemptions of investment company's shares.

5. Sales and promotional activities.

The Commission's authority for examining the accounts, books and other records of registered investment companies and those of their investment advisers, principal underwriters and depositors, which are necessary to record such persons transactions with such registered companies, is contained in Section 31(b) of the Act. Although the staff has statutory authority regarding access to investment company records, the examiner normally will find that a relaxed, but professional, courteous approach greatly aids the working relationship with the registrant and their willingness to cooperate in supplying documents and information in response to requests.

B. Use of the Examination Outline

The "Investment Company Examination Outline" 1/ sets forth the areas to be reviewed during inspections. The items in the Outline are grouped into four categories as follows:

1. Financial Analysis (Accounting)

2. Investment Activities

3. Management Functions

4. Sales and Liquidations of Investment Company's Shares

1/ See Appendices I-D and I-E, relating to Facing Pages for Investment Company Examination Reports and Investment Company Inspection Outline (Examination Outline), respectively.

Many of the items in the Outline are self-explanatory and may not require further discussion as to the manner in which such reviews should be made. Other items are best reviewed by preparing workpapers and making detailed analyses. Part II of this manual contains instructions, discussions, and suggested procedures for conducting investment company examinations. To more easily follow these procedures and discussions, Part II has been structured to parallel the Examination Outline. Please remember that the Examination Outline is only a guide. Hopefully, it will serve as a "stepping stone" in pursuing other matters of suspicion not covered in the Examination Outline.

Records of the registrant used by examiners should be used and handled in a manner such that they are returned to the registrant exactly as received. Documents and copies retained by the examiners for their workpapers should not be marked on or defaced, except to the extent that the date and source of the document should be written on the back. It is helpful to have document folders in which to keep and protect documents for workpapers.

During the examination, the examiner in charge should collect all workpapers as they are turned in. He should review these and make sure that he understands each one. He should enter as much information as possible in the "Examination Outline" and maintain notes on all important discussions, including a list of persons interviewed. He should maintain a list of all records inspected and any deficiencies noted. If problem areas are encountered, he should have these followed up and obtain as much pertinent information and documentation as possible. The Outline should contain pencil written comments on each item listed. The comments should indicate whether or not the item was reviewed during the examination, the extent of the review, reference to workpapers or other exhibits, description of deficiencies noted, and any other comments.

C. Expressions of Conclusions During Examinations

Unless expressly authorized, interpretations should not be given and conclusions should not be expressed with respect to any problems which require legal or policy determinations. Matters such as bookkeeping deficiencies may be discussed, but it should be made clear in doing so that no definitive determination with respect thereto will be made during the examination. Requests for legal or policy determinations should be submitted by the company in writing to the Regional Administrator or to the Division of Investment Management. Areas of possible violations should be pursued, of course, but only for the purposes of obtaining further information. The examiner in charge should be aware of all such matters, and he, in turn, should immediately contact his superior at the Regional Office when any questions arise as to any serious violations or areas of possible sensitivity.

D. Disruption of Investment Company's Operations During Examinations

Examiners should make every effort to minimize the disruption of the operations of the company under examination. If a needed record is being used by company personnel, it is usually possible to go to another step of the examination involving records not in use, until the needed records are available.

Some phases of the examination can best be conducted at the Regional Office after certain basic information is obtained at the investment company's offices. Some of these are:

1. Review of portfolio transaction executions
2. Review of valuations of portfolio securities
3. Affiliations of Board of Directors
4. Composition of Investment Portfolio
5. Capital Structure
6. Circular and Cross Ownership

E. Examinations of Related Investment Companies

Often, two or more investment companies to be examined will be under the same or related management, and the operations of such companies will involve the use of common or closely related personnel, facilities and procedures. This often occurs, for example, in cases where open-end companies have the same investment adviser or principal underwriter, or where an open-end company's investment adviser or principal underwriter is the depositor of a unit investment trust which invests certificate holders' payments in shares of the open-end company. In such cases it will ordinarily be possible to combine the review of certain procedures for all companies being examined, such as those involving investment decisions, sales, liquidations, determination of net asset value, and so forth. In many cases the examination of all related companies can be covered in a single combined report. The method for examining a complex of funds will be determined by the examiner in charge. The decision of dividing the assignments among the examination team members by functions, companies or a combination thereof will depend on each particular situation.

F. Period of Time to be Covered by the Examination

Examinations should ordinarily be concentrated on a period of operations of approximately one year preceding the date of examination. Test checks employed with respect to particular matters may cover a longer or shorter period. The length of the period and the extent of the sampling should be sufficient to afford reasonable assurance that the facts obtained support the conclusions reached as to compliance with applicable standards. When problems are noted or suspected, it may be appropriate to review procedures and operations associated with such problems for periods preceding the past year.

G. Use of Copies of Statutes and Rules as Checklists and Reference Guides

During the examinations, maximum use should be made of published statutes and regulations as checklists or reference guides. This practice has many advantages including the fact that such materials are public and may be freely displayed during the examination. Furthermore, such materials are readily accessible and are usually in reasonably current form.

PART II. INVESTMENT COMPANY EXAMINATION PROCEDURES

FINANCIAL ANALYSIS

1. ACCOUNTING RECORDS OF THE INVESTMENT COMPANY

Section 31(a) of the Act requires every registered investment company, every underwriter, broker, dealer or investment adviser which is a majority-owned subsidiary of the investment company, and every investment adviser not a majority-owned subsidiary and every depositor or an investment company and every principal underwriter of any investment company to maintain and preserve accounts, books and other documents constituting its financial record.

Section 31(b) requires that all records maintained pursuant to Section 31(a) be subject to examination by the staff of the Commission.

Section 31(c) authorizes the Commission to promulgate rules and regulations concerning the maintenance of books and records and the preparation of financial statements.

Rule 31a-1 under the Act describes those records which are required to be maintained by registered investment companies, certain majority-owned subsidiaries thereof, and other persons having transactions with investment companies. Paragraph (a) under the Rule requires that the accounts, books, and other documents relating to the investment company's business, which constitute the record forming the basis for financial statements and auditor certificates required to be filed with the Commission, be maintained and kept current. Paragraph (b) of the Rule itemizes the records that must be maintained and specifies the information that they should reflect. Paragraphs (c), (d), (e), and (f) describe the accounts, books, records, and documents that are required to be maintained by certain other related persons.

Rule 31a-2 describes those records which are required to be preserved by registered investment companies, certain majority-owned subsidiaries thereof, and other persons having transactions with registered investment companies. The Rule specifies the periods for which various records should be preserved, and the form (i.e. microfilm, etc.) in which they may be stored.

Rule 31a-3 states that if records required to be maintained and preserved pursuant to Rules 31a-1 and 31a-2 are maintained or preserved by others than the persons required to maintain or preserve such records, a written agreement is necessary. Where a bank or member of a national securities exchange acts as custodian, transfer agent, or dividend disbursing agent, such bank or exchange member must agree in writing to make any records relating to such service available upon request and to preserve records required by Rule

31a-1 so as to conform with Rule 31a-2. Parties other than banks or exchange members performing custodian, transfer agent, or dividend disbursing services must agree in writing that the related records are the property of the person required to maintain and preserve such records and will be surrendered promptly upon request.

At the outset of the examination, the examiners should inquire where and by whom the required ledgers, journals, and other records are maintained. Where open-end companies are involved, the basic records such as the journals, subsidiary ledgers, and general ledger will usually be maintained at or near the location where the daily net asset value calculations are made.

The examination should include a review of the books and records which are required to be maintained by Rule 31a-1 to insure that they reflect all of the information required by the Rule. Deficiencies, if any, should be noted including the failure to keep the required books and records current. Minor deficiencies which are corrected prior to the completion of the inspection should be noted as having been corrected.

The review of books and records can be facilitated by the examiners if they, during other phases of the examination, check for compliance with the requirements of Rule 31a-1 each time that they use a record in connection with the review of a particular activity or for the extraction of information. Towards the completion of the examination they should collaborate and after determining which records have not been examined, make a special review of those. In some cases however, particularly when numerous bookkeeping problems are noted or suspected, an independent review of all required records may be considered appropriate.

The examination should also include a review of the investment company's practices in connection with the preservation of records, and a determination should be made as to compliance with the provisions of Rule 31a-2.

If records required to be maintained and preserved pursuant to Rules 31a-1 and 31a-2 are prepared and maintained by others, a determination should be made as to compliance with the provisions of Rule 31a-3. The written agreement required by the Rule should be examined. If a visit to the agent is made in connection with other phases of the examination, a review for compliance with Rules 31a-1, 31a-2, and 31a-3 can be included and conducted on the agent's premises.

A current copy of the published General Rules and Regulations under the Act can serve as a useful check-list in conducting the above reviews.

2. CALCULATION OF NET ASSET VALUE

Open-end investment companies usually make calculations of net asset value once each day, at the time of the close of the New York Stock Exchange. This is necessary because Rule 22c-1 under the Act requires that all sales

and liquidations of redeemable shares must be at a price based on the current net asset value of such shares. The Rule further states that the current net asset value of any such security shall be computed (i) no less frequently than once daily on each day (other than a day during which no such security was tendered for redemption and no order to purchase or sell such security was received by the investment company) in which there is a sufficient degree of trading in the investment company's portfolio securities that the current net asset value of the investment company's securities might be materially affected by changes in the value of the portfolio securities and (ii) at such specific time during the day as determined by a majority of the board of directors of the investment company no less frequently than annually. A calculation is therefore required to be made at least once each day that shares are sold or liquidated. In addition, many investment companies have their share quotations published daily which, even if no shares are transacted, makes a daily calculation of net asset value necessary.

Rule 2a-4 under the Act sets forth certain requirements involving the manner in which certain of the investment company's asset, liability, income, expense, and capital accounts should be reflected in "current net asset value calculation." Section 2(a)(41) under the Act defines the term "value" when used with respect to assets of registered investment companies. Both the Rule and the Section require than an investment company's assets be valued at "current market value." A company's portfolio securities for which quotations are readily available should reflect a value based on such quotations. Securities and other assets for which quotations are not readily available should reflect a value as determined in good faith by the board of directors of the investment company. 1,2/ It is recognized that different types of investment companies pose different problems as to portfolio valuation.

In its simplest form, making a net asset value calculation would involve the following steps:

1. Post the general ledger from the various journals.

2. Take a trial balance of the currently posted general ledger accounts.

3. Value each portfolio security on the basis of that day's closing market quotations.

1/ See Appendix I-G-1, Investment Company Act Release No. 5847, Restricted Securities.

2/ See Appendix I-G-2, Investment Company Act Release No. 6295, Accounting for Investment Securities by Registered Investment Companies.

4. Where readily available market quotations are unavailable, attempt to value such securities in a reasonable manner on a "best effort" basis utilizing a method or methods of your choosing.

5. Adjust the book value of the investment portfolio for appreciation or depreciation.

6. Subtract total liabilities from total assets at market to arrive at total net asset value.

7. Divide total net asset value by number of shares outstanding to arrive at net asset value per share.

In practice, however, various methods of calculating net asset value are used. Rather than basing the calculation on a trial balance or its equivalent, many companies use one of a variety of similar methods. Many of these involve daily posting to a few combined accounts directly from the journals, without posting to the general ledger except at month-ends. The summary accounts make up what is generally referred to as the "pricing sheet" with relatively few items into which all assets and liabilities are grouped. The following work-sheet is an example of a sample form of pricing sheet and its relationship to a general ledger trial balance.

General Ledger Trial Balance

Account	Dr	Cr
Cash	751,000	
Investments at Cost	9,175,000 (Mkt. 9,226,670)	
Accounts Receivable Fund Shares	165,150	
Accounts Receivable Portfolio Trades	163,250	
Dividends Receivable	36,120	
Treasury Stock	1,675	
Acc. Payable - Fund Shares		12,695
Acc. Payable - Port. Trades		59,695
Fees Payable		39,120
Management Fee Expense	122,950	
Custodian & Transfer Agent Fee Expense	10,175	
Printing Expense	1,395	
Other Expense	16,170	
Dividend Income		27,395
Gain on Sale of Sec's		127,165
Capital Stock $1 Par		1,000,000
Capital Surplus		9,000,000
Earned Surplus (Prior periods)		176,815
	10,442,885	10,442,885

Pricing Sheet

Cash	751,000
Investments at Market (Cost 9,175,000)	9,226,670
Total Receivables	364,520
Total Assets	10,342,190
Total Payables	111,510
Total Liabilities	111,510
Net Asset Value	10,230,680
Capital Shares Issued	1,000,000
Less treasury stock	1,675
Shares Outstanding	998,325 shares
Net asset value per share	10.25

During examinations, a detailed inquiry should be made into the methods used in calculating net asset value and the public offering price of shares. The examination should include a close review of a recent net asset value calculation. The following are two procedures which may be used in making this review. If a closed-end company is being examined, similar procedures may be employed in reviewing net asset value calculations appearing in recent shareholder reports, etc.

I. Reconcilement of General Ledger to Pricing Sheet on an Item by Item Basis

A. Extract, or otherwise obtain a copy for retention, a trial balance of the company's general ledger accounts as of a selected date. If a copy of a trial balance is used, compare the balances in each account directly against the general ledger.

B. Obtain, for retention, a copy of the pricing calculation used by the company on the same date, including the valuation of portfolio securities.

C. Check securities positions as they appear on pricing sheet against those reflected in the securities ledger. If the securities position are exactly the same, the difference between the general ledger balance which usually reflects cost, and the pricing sheet market valuation is the total appreciation or depreciation of the company's portfolio. If the positions vary, appropriate adjustments must be made. Adjust the trial balance to reflect the depreciation or appreciation of the portfolio.

D. Reconcile each item on the general ledger trial balance (as adjusted to reflect the market value of the investment portfolio) to the price sheet. A worksheet similar to the one shown on Page 33 may be used in making the reconcilements. If a difference between the pricing sheet and the trial balance is noted and the difference amounts to more than 1 cent per share above or below net asset value, a further examination should be conducted until the cause of the difference is located. Obviously, whether the amount of the deviation is "material" may serve as a better guide depending on the circumstances.

II. Independent Calculation of Net Asset Value

A. Using a worksheet similar to that which appears on Page 33, follow Steps A, B, and C as described in Procedure I above.

B. Working from the trial balance, subtract total liabilities from total assets (adjusted to market) and determine total net asset value. Divide by the number of outstanding shares as they are reflected by the trial balance to determine the net asset value per share. Remember to apply shares in the Treasury Stock accounts against the shares in the Capital Stock accounts to arrive at the correct number of shares outstanding. If the difference between the net asset value per share so calculated deviates by more than 1 cent per share in either direction from the pricing sheet calculation, a further check should be made on an item by item basis until the difference is found.

C. Some investment companies do not reflect certain items on their general ledger as of the same time that such items are reflected on the pricing sheet. For example, changes in portfolio securities should be reflected on the pricing sheet on the day following trade date as required by Rule 2a-4. These trades, however, are sometimes not posted to the general ledger until the confirmation is received, usually a day later. Similar lags may exist as to investment company shares outstanding. Because, in such cases, offsetting entries to the appropriate payable or receivable accounts will also not be made, these posting lags should not affect the examiner's <u>independent calculation</u> of net asset value per share as long as the shares outstanding and the portfolio appreciation or depreciation figures used in the examiner's calculation are based on the positions reflected in the general ledger. In such cases, the shares outstanding balance should pose no problem since it is readily available from the general ledger. The portfolio valuation requires an adjustment, however, which can easily be made if the securities in which differences in position are noted are scheduled at the time the pricing sheet positions are checked to the securities ledger. In addition, most investment advisers are paid a management fee based on the daily net asset value of the investment company. Failure to compute the daily net asset value because of a lack of share transactions for a particular day may be in contravention of the advisory contract. An examiner, in making an independent calculation, should reconcile this contract requirement with actual practice.

Sample Worksheet for Making Independent Calculation of Net Asset Value

CALCULATION OF NET ASSET VALUE

Trial Balance

Account	Dr	Cr	Assets	Liabilities	Capital
Cash	751,000		751,000		
Investments at Cost	9,175,000		9,175,000		
Accounts Receivable Fund Shares	165,150		165,150		
Accounts Receivable Portfolio Trades	163,250		163,250		
Dividends Receivable	36,120		36,120		
Treasury Stock	1,675				
Acc. Payable - Fund Shares		12,695		12,695	(1,675)
Acc. Payable - Port. Trades		59,695		59,695	
Fees Payable		39,120		39,120	
Management Fee Expense	122,950				(122,950)
Custodian & Transfer Agent Fee Expense	10,175				(10,175)
Printing Expense	1,395				(1,395)
Other Expenses	16,170				(16,170)
Dividend Income		27,395			27,395
Gain on Sale of Sec's		127,165			127,165
Capital Stock $1 Par		1,000,000			1,000,000
Capital Surplus		9,000,000			9,000,000
Earned Surplus (prior periods)		176,815			176,815
			Portfolio Appreciation 51,670		51,670
	10,422,885	10,442,885	10,342,190	115,510	10,230,680
				Shares out.	998,325
				NAV	$10.25

In using either of the aforementioned procedures, check, at least on a test basis, values assigned to portfolio securities.

Valuations for unrestricted securities should be checked against available published quotations for the date of calculation. The valuation of assets for which market quotations are not available should be reviewed for compliance with Investment Company Act Release No. 5847 and 6295. 1/, 2/ A thorough inquiry should be made as to methods of valuing such securities including an appropriate review as to whether such assets and securities are valued in "good faith." This should include a review of the information or procedures used by the directors in making their valuation. Check also that portfolio companies for which quotations cannot be found, actually exist.

Some investment companies have contracted with brokers, banks, service agents or other outside parties for the pricing of the portfolio securities and related functions, including the computation of net asset value per share. In such instances, the examiner should obtain as much information as he can regarding the following.

1. The "services" being rendered.

2. How the outside party is compensated for its services.

3. What source the outside party uses for prices.

4. The extent of review procedures, monitoring and control by the investment company over the outside party.

5. Formal evaluation and approval by the investment company's Board of Directors of the pricing procedure.

6. (a) Does the outside service also value restricted or other securities for which market quotations are not available and, if so, does it follow an "automatic formula" contrary to Rule 2a-4 as interpreted in Investment Company Act Release No. 5847?

   (b) Does the procedure by which the outside party values restricted securities conflict with the Board of Directors' responsibility in Rule 2a-4?

1/ See Appendix I-G-1, Investment Company Act Release No. 5847, Restricted Securities.

2/ See Appendix I-G-2, Investment Company Act Release No. 6295, Accounting for Investment Securities by Registered Investment Companies.

7. How do auditors confirm the prices of portfolio securities?

8. What records, if any, does the outside party maintain regarding the prices communicated to the fund or its agent?

9. Are there any other parties involved in the pricing procedure?

Review the procedures used by investment companies in making the pricing calculation for compliance with the provisions of Rule 2a-4. A copy of the published General Rules and Regulations under the Act can be used as a checklist in making this review. Check also that actual methods of pricing are consistent with disclosures in the prospectus and shareholder reports. See that pricing methods are uniformly and consistently applied.

As a further check for proper calculation of net asset value, review past pricing sheets as of recent audit dates to see whether or not the net asset value per share as calculated on those dates agreed to the net asset value as calculated by the auditors. A detailed inquiry should be made into differences of more than 1 cent per share or of an amount deemed to be material by the examiner.

Verification and Analysis of Accounts

Regardless of which procedure is used to check the net asset value calculation, a trial balance should be prepared from the general ledger (or otherwise obtained and checked against the general ledger) during all investment company inspections. At a minimum, the following accounts should be verified and analysed. 1/ Similar, appropriate methods should be used to examine other accounts in which unusual activity is noted or which appear to warrant review.

Account Verifications

Cash	-	Verify by obtaining statement from depository bank and reconciling to general ledger balance.
Investments	-	Verify by physical count or obtaining confirmation from custodian and reconciling to securities ledger.
Outstanding shares	-	Verify by obtaining confirmation from transfer agent and reconciling to general ledger balance.

1/ As will be seen later in the manual, the analyses and verifications obtained at this time will be used to assist with other aspects of the examination.

Account Analysis

Accounts Payable and Receivable/ Open Portfolio Transactions -

Prepare detailed breakdown including dates of transactions. Inquire into outdated or stale items.

Accounts Payable and Receivable/ Fund Share Transactions -

Prepare detailed breakdown including dates of transactions. Inquire into stale or outdated items, especially sizable purchases of fund shares on accounts.

Expenses - Prepare detailed breakdown. If accruals are used, check for accuracy. Ascertain that all fund expenses are consistent with existing contracts. Determine whether any of the expenses are being booked and/or billed on a net basis. If so, request information as to the nature of any discount or indirect offset of such expenses.

3. CAPITAL STRUCTURE

The capital structure of registered investment companies is limited by Section 18 of the Act. Pursuant to Section 18(a), closed-end companies are allowed to issue senior securities including borrowings from a bank, bonds, debentures, and preferred stock, to obtain leverage for their common stockholders. Section 18(c) limits such companies to only one class of senior securities outstanding representing indebtedness and one class of senior securities outstanding representing a stock. If a closed-end company raises capital through the use of leverage, the company must have a ratio of "asset coverage" to debt of at least three to one. If additional capital is raised through a class of stock, the required "asset coverage ratio" is two to one.

Pursuant to Section 18(f), open-end companies are not permitted to issue senior securities including bonds or debentures. The use of bank loans is permitted, however, but restricted by a three to one "asset coverage" requirement. Section 18(h) defines the term "asset coverage" as follows:

> "Asset coverage" of a class of senior security representing an indebtedness of an issuer means the ratio which the value of the total assets of such issuer, less all liabilities and indebtedness not represented by senior securities, bears to the aggregate amount of senior securities representing indebtedness of such issuer. "Asset coverage" of a class of senior security of an issuer which is a stock means the ratio which the value of the total assets of such issuer,

less all liabilities and indebtedness not represented by senior securities, bears to the aggregate amount of senior securities representing indebtedness of such issuer plus the aggregate of the involuntary liquidation preference of such class of senior security which is a stock."

Section 18(i) requires that every share of stock issued by a registered management investment company (except certain common law trusts) shall be voting shares and shall have equal voting rights with every other outstanding voting stock.

During examinations, the investment company's trial balance and general ledger accounts should be carefully reviewed for indications of obtaining capital through the issuance of "senior securities." Look particularly at the company's debt (liability) accounts, and its capital accounts. Large cash receipts or payments reflected in the cash journals may indicate activity in issuing senior securities. A review of expenses incurred or paid may turn up indications of interest payments related to senior securities. Where such indications are noted, a check for compliance with the applicable provisions of Section 18 should be made.

Short Sales and Options

Section 12(a) of the Act permits registered investment companies to effect short sales except in contravention of rules and regulations of the Commission. To date, no such rules have been adopted. However, Section 18 of the Act contains limitations upon the issuance of senior securities, including a provision that an open-end company may not issue senior securities, except that it may borrow from any bank.

A short sale involves the creation of a senior security as defined in Section 18(g) in that a short sale typically involves the borrowing of stock from an entity other than a bank, thereby creating an indebtedness to an entity other than a bank. Since an open-end investment company cannot issue senior securities and can only borrow from a bank, in order to comply with the provisions of Section 18, the short selling open-end investment company must put in a segregated account (not with the broker) an amount of cash or U.S. government securities equal to the difference between (a) the market value of the securities sold and (b) any cash or U.S. government securities required to be deposited as collateral with the broker in connection with the short sale (not including the proceeds from the sale). In addition, until the company replaces the borrowed security, it must daily maintain the segregated account at such a level that (1) the amount deposited in it plus the amount on deposit with the broker as collateral will equal the current market value of the securities sold short, and (2) the amount deposited in it plus the amount deposited with the broker as collateral will not be less than the market value of the securities at the time they were sold short. This in effect nullifies the borrowing.

If the open-end investment company owns the security which is sold short, that is, a short sale against the box, a senior security still is created, but the borrowing is cured if the custodian, pursuant to instructions of the investment company, restricts the sale of the security held which collateralizes the short position so that the investment company's obligation is covered for the duration of the short position.

With respect to a closed-end company, any short sale which does not include the arrangements described above with reference to open-end companies is considered to involve the creation of a senior security and is subject to the provisions of Section 18(a)(1). Likewise, any closed-end company that writes options that do not include the arrangements described below, should comply with Section 18(a)(1).

The writing of put and call options is also subject to certain restrictions in order that it not result in the issuance of senior securities in violation of Section 18 of the Investment Company Act. There are two ways an investment company may write call options. The first is that the call be "covered." For the call option to be covered, the investment company must either own the underlying securities or own, on a share-for-share basis, a call of the same "class" as the call written where the exercise price of the call held is equal to or less than the exercise price of the call written. The second way an investment company may write call options and comply with Section 18 of the Act is to maintain in a segregated account, described below, cash, U.S. government securities or high grade debt securities equal to the market value of the optioned securities.

There are two ways an investment company can write put options and comply with Section 18. One is to write covered put options. A put option is covered if the writer holds, on a share-for-share basis, a put of the same "class" as the put written where the exercise price of the put held is equal to or greater than the exercise price of the put written. The second way is for the investment company to maintain in a segregated account cash, U.S. government securities or high grade debt securities in an amount equal to the funds that would be necessary to purchase the securities underlying the put.

Generally, the broker through whom the uncovered option is written will require that the amount in the segregated account, which is marked daily to the market, be collateralized or secured by the investment company's obligation to deliver the underlying security if the option written is a call or to buy the underlying security if the option written is put. This necessitates an agreement between the investment company, the custodian and the broker whereby the investment company agrees to segregate and pledge cash or certain other assets, using a special account at the custodian to protect the broker and satisfy margin requirements and Regulation T.

4. DIVIDEND PAYMENTS TO SHAREHOLDERS

Section 19 of the Investment Company Act requires that a registered investment company make dividend payments to shareholders only from (1) accumulated undistributed net income not including capital gains and losses; or (2) such company's net income for the current or preceding fiscal year; unless the payment is accompanied by a written statement adequately disclosing the sources of the payment. The requirements involving the written statement are specified in Rule 19a-1 under the Act.

Rule 19b-1 requires, generally, that capital gain distributions be limited in frequency to not more than once each taxable year.

In addition, when investment companies make pro rata stock distributions to shareholders, certain generally accepted accounting standards must be met. 1/ Such distributions may be considered misleading if, when the ratio of such distributions is less than 25% of shares of the same class outstanding, the fair value of the shares issued is not transferred from retained earnings to other capital accounts. Basically, what is involved here is that stock distributions of less than 25% could be considered by the recipient to be non-cash distributions of earnings. Therefore in the absence of such earnings, such distributions are considered as being misleading.

During examinations, all distributions to shareholders during the period covered by the examination should be reviewed. The review should include the accounting entries involving the payments. Copies of statements accompanying distribution payments should be obtained from the company and checked for compliance with Rule 19a-1. A copy of the Rule could serve as a check list in making the review.

INVESTMENT ACTIVITIES

5. INVESTMENT DECISIONS

An "investment adviser" to an investment company is defined in Section 2(a)(20) of the Act. It is any person (or corporation, etc.) who regularly furnishes advice to an investment company pursuant to a contract, or any person who is empowered to determine what securities or other property shall be purchased or sold by the investment company. Such advisers are required to be registered with the Commission pursuant to Section 203 of the Advisers Act. The definition under the Act does not include a person who furnishes only statistical and other factual information or advice on occasional transactions, a person whose advice is furnished through publications issued to subscribers or a company furnishing advisory services at cost to one or more financial institutions, insurance companies or investment companies.

1/ See Appendix I-L-1, Accounting Series Release No. 124, Pro Rata Stock Distributions to Shareholders.

Section 15(a) of the Act requires that an investment adviser to an investment company must serve or act pursuant to a written contract which has been approved by the majority of the outstanding voting shares of the investment company.

The roles played by an investment company's investment adviser, sub-adviser, board of directors, executive committee, investment committee, advisory board, and other groups of individuals, as they relate to investment portfolio decisions, vary from one investment company complex to another. For example, some investment advisers merely make investment recommendations on a non-discretionary basis to an investment company, and the actual decision to execute a portfolio transaction is made by an individual or committee of the investment company. In other cases, the investment adviser is not involved in the investment decision process or is only involved in a small way, having delegated that function to a sub-adviser. In most situations involving investment companies, investment advisers have complete discretionary authority to make final investment decisions and execute portfolio transactions. Many times, individuals who are involved in the investment decision making process have overlapping functions and positions because they hold concurrent positions or titles in both the investment company and its investment adviser.

During investment company examinations, it is an important, and sometimes difficult, task to determine exactly what roles are played by the different parties, groups, or individuals involved in the investment decision making process. If an individual holding concurrent titles or positions with the investment company and its adviser is involved, the examiner should ascertain which "hat he is wearing" during the performance of functions relating to investment decisions. In some cases, it is not uncommon for the principals themselves not to be aware of these "technicalities." When this occurs, the examiner should insist that specific answers be sought and furnished.

The information is best obtained by interviewing and observing those persons who are directly involved in the investment decision making process. The examiner should inquire and observe how investment ideas originate, how the selection of issues to be purchased or sold is made, how actual transactions are authorized, how broader policies are determined, and what information is received by the investment company's directors.

An inquiry should be made into whether or not outside financial services are employed and the nature of such services. The information requested from the company at the outset of the examination involving the staff of the adviser should be reviewed and a determination made as to whether or not the staff is adequate to perform the required duties.

Using all of the above information, a determination should then be made as to whether or not there are any undisclosed investment advisers not performing pursuant to contract as required by Section 15(a), and as to whether or not the investment adviser can competently perform those functions agreed to in the advisory contract and represented in the Fund's prospectus. The

knowledge gained during this phase of the examination will also be used in connection with other aspects of the examination, particularly those involving a review of the investment adviser contract covered in Item 9 of the Outline and Manual.

6. TRANSACTIONS IN PORTFOLIO SECURITIES

With the advent of negotiated commission rates, all orders for transactions in portfolio securities placed on behalf of investment companies must be placed with the primary intention of obtaining best execution. 1/ In addition to certain specific prohibitions relating to portfolio transactions contained in the Act discussed below, misconduct or negligence in connection with such transactions may constitute a breach of fiduciary duty. Section 36 of the Act authorizes the Commission to bring action against certain persons involved in misconduct or negligence which constitute a breach of fiduciary duty. Violations of other Federal securities laws and regulations including certain anti-fraud and disclosure provisions may also be involved in such cases.

Section 17(a), 17(d), 17(e), and 10(f) of the Act contain specific prohibitions applicable to trading practices. In every case, the prohibitions apply to affiliated persons and affiliated persons of such persons. Some also apply to promoters, principal underwriters, others and their affiliates.

An affiliated person is defined in Section 2(a) of the Act as follows:

> "Affiliated Person" of another person means (A) any person directly or indirectly owning, controlling, or holding with power to vote, 5 per centum or more of the outstanding voting securities of such other person; (B) any person 5 per centum or more of whose outstanding voting securities are directly or indirectly owned, controlled, or held with power to vote, by such other person; (C) any person directly or indirectly controlling, controlled by, or under common control, with such other person; (D) any officer, director, partner, copartner, or employee of such other person; (E) if such other person is an investment adviser thereof or any member of an advisory board thereof; and (F) if such other person is an unincorporated investment company not having a board of directors, the depositor thereof.

1/ In 1975, Congress adopted Section 28(e) of the Exchange Act which relieves investment managers, when acting in good faith, of certain liabilities that might have accrued to them if they caused accounts which they manage to pay brokerage commission at rates in excess of the lowest rates available in consideration of the value of brokerage and research services provided by the broker to whom the commissions were paid.

Section 17(a) of the Act generally prohibits an affiliated person, promoter, or principal underwriter for a registered investment company, or any affiliated person of such a person, promoter, or principal underwriter, acting as principal, from selling or purchasing property or securities from the investment company, and from borrowing money from the company, with few minor exceptions.

Section 17(d) of the Act and Rule 17d-1 thereunder generally prohibit affiliated persons and principal underwriters of registered investment companies, and affiliated persons of such persons and principal underwriter, acting as principal, from participating in, or effecting any transaction in connection with, any joint enterprise or other joint arrangement or profit sharing plan in which the investment company is a participant.

Section 17(e) of the Act generally prohibits affiliated persons of a registered investment company, or affiliated persons of such persons, acting as agent, from accepting any compensation for the purchase or sale of any property or securities to or for the investment company, except in the course of such person's business as an underwriter or broker. Commission rates to brokers, who are affiliated persons of the investment company, or are affiliated persons of such persons, is generally on a basis which is equivalent to brokerage rates paid by the affiliate's most favored customers. Moreover, such commission rates should be competitive to those provided by other unaffiliated brokers in terms of price and execution rendered.

Section 10(f) of the Act generally prohibits registered investment companies from purchasing or otherwise acquiring, during the existence of any underwriting or selling syndicate, any security, a principal underwriter of which is an officer, director, member of an advisory board, investment adviser, or employee of the investment company, or a person of which any such officer, director, member of an advisory board, investment adviser, or employee is an affiliated person. To acquire securities, which are otherwise prohibited by Section 10(f) of the Act, Rule 10f-3 sets forth the conditions in which an investment company can purchase either municipal or publicly-issured securities in which its principal underwriter or an affiliate is a participant in the underwriting syndicate. The conditions of the rule are fairly extensive, and accordingly, the examiner is referred to the rule for specifics. It is suggested that the examiner utilize the rule as a checklist when verifying compliance.

Thus, an affiliated person, promoter, or principal underwriter of a registered investment company or an affiliated person of such persons is restricted by the Act in his dealing with the investment company. Without meeting the conditions for exception or the receipt of a Commission order for exemption, he may not sell to, or purchase any security or other property from a registered company or any company controlled by a registered company. He may not borrow money or other property from a registered company or one controlled by such company. He may not effect any transaction in which a registered company is a joint or joint and several participant. He cannot accept compensation as an agent from any source for the purchase and sale of any property to a registered company except in the ordinary course of his business if he is an underwriter or broker.

Furthermore, pursuant to fiduciary obligations, those persons responsible for placing orders for transactions on behalf of investment companies, must seek the best possible execution of those orders. Prospectus disclosures in connection with the placing of such orders must, of course, be consistent with actual practices. Moreover, such prospectus disclosure should include a discussion of any additional services (e.g. statistical, quotation and research information) which are rendered the investment company and/or its investment adviser as part of brokerage placement practices.

During investment company examinations, it is important to determine (1) the quality of execution of portfolio security transactions including those which involve listed securities (third market); (2) that affiliated persons, or their affiliates, are not being used to execute portfolio transactions on a principal basis; (3) that, except as permitted by Rule 10f-3 of the Act, the company has not acquired securities during the existence of any underwriting syndicate of which an affiliated person or affiliate of such a person, is a principal underwriter; (4) that orders are placed with the intention of seeking the best possible execution and that broker-dealers have not been unnecessarily interpositioned in transactions thereby increasing the costs of execution; (5) that the company pays only the necessary commission, particularly with respect to volume discounts and negotiated rates; (6) that any research or services rendered by broker-dealers is consistent with the provisions of Section 28(e) of the Exchange Act and prospectus disclosure; (7) that pursuant to arrangement or otherwise, affiliated persons, or their affiliates are not receiving unlawful compensation in connection with the execution of portfolio transactions and (8) that the company is not participating in joint ventures with affiliated persons or their affiliates.

It should be recognized that investment companies are not precluded from allocating portfolio brokerage to broker-dealers who sell fund shares. With the recent amendment in 1981 to the NASD Anti-Reciprocal Rule, NASD members are explicitly permitted to sell shares of funds which follow a disclosed policy of considering sales of their shares as a factor in the selection of broker-dealers to execute portfolio transactions, subject to best execution. Examiners should inquire: (a) whether sale of fund shares is a factor of consideration in determining the allocation of investment portfolio brokerage, (b) what formal documentation (e.g. investment advisory contracts and board of directors minutes) permits or sanctions this factor to be considered, and (c) the manner in which this factor is reflected in the fund's books and records, especially Rule 31a-1(b)(9) of the Act.

Confirmations of portfolio transactions effected by the investment company during the period immediately preceding the date of examination should be obtained for the purpose of scheduling various types of transactions to the extent deemed necessary. The confirmations may, if circumstances warrant, be checked against the company's purchase and sale journal to insure that all confirmations covering the selected period are included. From the confirmations, the examiner should schedule a representative number of various types of transactions particularly the following, recording details as to trade dates, quantities, description, prices, commissions paid if executed on an agency basis, cost or proceeds, names of executing broker-dealers, markets where executed, and all other pertinent information:

A. Transactions in listed securities executed on the over-the-counter market.

B. Transactions in unlisted securities.

C. Block transactions in unrestricted securities including exchange transactions involving quantity discounts and negotiated commission rates.

D. Transactions involving securities and other investments which are restricted as to resale (private placements). 1/

1/ See Appendix I-G-1, Investment Company Act Release No. 5847, Restricted Securities.

E. All other transactions which may be unusual or which arouse suspicion. Such transactions and the surrounding circumstances should be reported whether or not clear violations are included.

The following is a series of worksheet forms which can be used as a guide to schedule and review various types of portfolio transactions. Schedules A through I are for use in reviewing specific types of transactions as titled. Schedule J is a combined form which can be used to transcribe several types of transactions directly from confirmations but requires that additional columns be set up as appropriate to complete the review. Obviously, the extent of any scheduling will vary in each situation. A representative sample or spot check of specific types of transactions should provide the examiner with insight on whether to pursue this matter in greater detail or to proceed with the examination. Scheduling, for scheduling-sake, is not the purpose or principal output of examinations.

SCHEDULE A BROKERAGE PURCHASES OF LISTED SECURITIES EFFECTED OFF THE EXCHANGE

Principal Exchange Where Listed	Trade Date	Quantity	Description	Price	Commissions			Exchange Price Range	
					Amount Paid	Total Cost	Broker	High	Low

SCHEDULE B BROKERAGE PURCHASES OF UNLISTED SECURITIES

Trade Date	Quantity	Description	Price	Commission			Published Offers	
				Amount Paid	Total Cost	Broker	High	Low

SCHEDULE C PRINCIPAL PURCHASES OF LISTED SECURITIES

Principal Exchange Where Listed	Trade Date	Quantity	Description	Price	Cost	seller	Exchange Price Range	
							High	Low

SCHEDULE D — PRINCIPAL SALES OF LISTED SECURITIES

Principal Exchange Where Listed	Trade Date	Quantity	Description	Price	Proceeds	Buyer	Exchange Price Range	
							High	Low

SCHEDULE E — PRINCIPAL SALES OF UNLISTED SECURITIES

Trade Date	Quantity	Description	Price	Proceeds	Buyer	Published Bids		Market Maker	
						High	Low	Yes	No

SCHEDULE F — PURCHASE OF NEW ISSUES ON PRINCIPAL BASIS

Trade Date	Effective Date of Underwriting	Description	Price	Proceeds	Broker	Broker Member Of Selling Group	
						Yes	No

SCHEDULE G — PRINCIPAL PURCHASES OF LISTED SECURITIES

Trade Date	Quantity	Description	Price	Cost	Seller	Published Offers		Market Maker	
						High	Low	Yes	No

SCHEDULE H — BROKERAGE SALES OF LISTED SECURITIES EFFECTED OFF THE EXCHANGE

Principal Exchange Where Listed	Trade Date	Quantity	Description	Price	Commissions Amount Paid	Proceeds	Buyer	Exchange Price Range	
								High	Low

SCHEDULE I — BROKERAGE SALES OF UNLISTED SECURITIES

Trade Date	Quality	Description	Price	Commissions Amount Paid	Net Proceeds	Broker	Published Bids	
							High	Low

SCHEDULE J — COMBINED FORM FOR REVIEWING VARIOUS TYPES OF TRANSACTIONS

Trade Date	Quantity		Description	Price	Commission Paid or (P) Principal	Cost or Proceeds	Executing BD	Market Where Executed
	Bot	Sold						

In addition to a review of specific transactions, the examiner should obtain the following information:

A. How and by whom are orders for the purchase and sale of portfolio securities placed.

B. Who actually selects executing broker-dealers, and what factors are considered. How are such broker-dealers solicited.

C. A description of any arrangements involving the placing of orders with broker-dealers particularly for the following purposes:

1. Sales of shares of the investment company, including all direct and indirect sales promotional efforts.

2. Advisory and research services provided to the investment company, its investment adviser, or other affiliated persons. 1/

3. Other services provided, such as the furnishing of quotations for pricing calculations.

D. A description of all arrangements involving the execution of transactions by affiliated broker-dealers, or by broker-dealers which are affiliates of affiliated persons.

1/ Of special interest to the examiner is the use of an investment company's assets to pay for additional research or statistical services including quotation and pricing services. Research services may be purchased either with "soft" or "hard dollars." If purchased with soft dollars, the cost for such services in addition to brokerage costs are included in the commission price, however, there is no specific dollar amount attached to these services. Research services purchased with hard dollars have a specific dollar amount assigned to their purchase.

An examiner should carefully review the nature of the services provided and the costs associated therewith. Moreover, the usefulness and primary recipient of this information should be determined. For example, if an investment company paid in soft dollars for research information, which was of greater interest to the investment adviser in managing a fund, either in the same complex or outside of the complex, it would be proper to question the propriety of this expenditure. Finally, any review of research expenses should include an analysis of the Board of Directors actions in approving, reviewing and monitoring these services. Such costs should warrant full consideration and review in the approval or renewal of an investment advisory contract.

E. A description of all transactions involving restricted securities. 1/ The investment company's files should be reviewed for information concerning the circumstances surrounding the execution of such transactions, particularly those involving the factors upon which the price was based.

Portfolio Turnover Rate

The investment company's most current prospectus or its registration statement under the Act should be reviewed to determine the company's policy with respect to portfolio turnover and its general investment objective. The examiner should then calculate the current portfolio turnover rate in the following manner:

1. The rate shall be calculated by dividing (A) the lesser of purchases or sales of portfolio securities for the particular fiscal year by (B) the monthly average of the value of the portfolio securities owned by the registrant during the particular fiscal year. Such monthly average shall be calculated by totaling the values of the portfolio securities as of the beginning and end of the first month of the particular fiscal year and as of the end of each of the succeeding eleven months, and dividing the sum by 13, except that the average value of securities for which market quotations are not available may be based upon the value of such securities as of the end of the preceding fiscal quarter.

2. For the purposes of this item, there shall be excluded from both the numerator and the denominator all U.S. Government securities (short-term and long-term) and all other securities whose maturities at the time of acquisition were one year or less. 2/ Purchases shall include any cash paid upon the conversion of one portfolio security into another. Purchases shall also include the cost of rights or warrants purchased. Sales shall include the net proceeds of the sale of rights or warrants. Sales shall also include the net proceeds of redemptions of portfolio securities by call or maturity.

1/ See Appendix I-G-1, Investment Company Act Release No. 5847, Restricted Securities.

2/ This formula does not accurately portray the portfolio activity of investment companies which principally invest in short-term securities and money market instruments. It is recognized that brokerage on such instruments is generally on a net basis and such securities are generally held through maturity. Thus, the calculation of an annual portfolio turnover rate for an investment company which invests principally in short-term securities should be minimal if not zero.

For the purposes of making a quick calculation of portfolio turnover without having need to extract data from an investment company's records, the so-called "Wharton Report" formula can be employed. Although less accurate than the N-1R method, it can be prepared directly from the company's latest annual or semi-annual report to shareholders even prior to the examination. The formula is as follows:

$$\frac{(P/S) \,/\, 2 \text{ Less Net Inflow or Net Outflow}}{A^1 - A^2 \,/\, 2}$$

P = Purchases of portfolio securities during period excluding short term and commercial paper and U.S. Governments.

S = Sales of portfolio securities during period excluding short term commercial paper and U.S. Governments.

Net Inflow or Net Outflow = Net monies received or paid out from sales and liquidations of investment company's shares.

A^1 = Net assets as beginning of period.

A^2 = Net assets at end of period.

Remember to adjust the result of either formula used to an annual rate if the period for which the data is taken involves more or less than one year. Do this by multiplying the resulting ratio from the formula by:

$$\frac{12}{\text{number of months in period used}}$$

If the portfolio turnover rate as calculated appears to contradict or is at variance with the investment company's policy and general investment objectives as described in its registration statement and prospectus, a detailed review and inquiry should be made to determine the reasons therefor.

Generally, the following guidelines can be used by examiners in determining whether or not an investment company's portfolio turnover approximates its stated investment objectives:

	Objectives	Portfolio Turnover
1.	Capital Appreciation through Long Term Investment	Less than 50%
2.	Capital Appreciation with Limited Short Term Trading	50% - 75%
3.	Capital Appreciation with Substantial Short Term Trading	100% - 200%
4.	Capital Appreciation through Short Term Trading	200% - 300%

The examiner should also take notice of whether the investment company is engaged in the practice of acquiring, disposing and reacquiring the same securities in a relatively short period of time. One approach to such a review is to examine the company's realized short term gains and losses. Indications of churning may also be sought from the investment company's securities ledger. A review of the ledger for this purpose can be combined with that part of the examination involving the review of the net asset value calculation in which the securities positions carried on the pricing sheet are checked against the securities ledger.

7. SECURITIES AND OTHER ASSETS OWNED BY THE INVESTMENT COMPANY

Investment companies are required to disclose all pertinent information involving their investment objectives and policies, including the methods or techniques which they intend to employ to pursue and achieve their stated objectives. These disclosures should appear in both the registration statement filed under the Securities Act and Act, and in the prospectus.

Section 13 of the Act prohibits an investment company from changing certain investment policies or the nature of its business so as not to be an investment company, without a majority vote of its outstanding voting securities. This Section reads in part as follows:

Changes in Investment Policy

Section 13(a). No registered investment company shall, unless authorized by the vote of a majority of its outstanding voting securities --

(1) change its subclassification as defined in Section 5(a)(1) and (2) of this title or its subclassification from a diversified to a non-diversified company;

(2) borrow money, issue senior securities, underwrite securities issued by other persons, purchase or sell real estate or commodities or make loans to other persons, except in each case in accordance with the recitals of policy contained in its registration statement in respect thereto;

(3) deviate from its policy in respect of concentration of investments in any particular industry or group of industries as recited in its registration statements, deviate from any investment policy which is changeable only if authorized by shareholder vote, or deviate from any policy recited in its registration statement pursuant to Section 8(b)(3);

(4) change the nature of its business so as to cease to be an investment company.

Section 5 of the Act subclassifies management companies as "open-end companies" or "closed-end companies" and further subdivides them into diversified and "non-diversified" companies. An open-end company is a management company which is offering for sale or has outstanding any redeemable security of which it is the issuer. A closed-end company is any other management company. A diversified company must have at least 75% of the value of its total assets represented by cash, cash items, government securities, securities of other investment companies, and other securities limited in respect of any one issuer to an amount not greater in value than 5% of the value of the total assets of the management company and not more than 10% of the outstanding voting securities of the issuer. A non-diversified company means any management company other than a diversified company.

Section 12(d) of the Act contains limitations as to the percentage of outstanding securities of another registered investment company that a registered investment company can own. Additionally, registered investment companies are restricted in their ownership of securities of insurance companies. Section 12(d) also provides that a registered investment company may not own a security in a person who is a broker-dealer, an underwriter, or an investment adviser.

Section 20(c) of the Act prohibits cross-ownership or circular-ownership of securities involving registered investment companies. The Section reads in part as follows:

> No registered investment company shall purchase any voting security if, to the knowledge of such registered company, cross-ownership or circular ownership exists, or after such acquisition will exist, between such registered company and the issuer of such security. Cross-ownership shall be deemed to exist between two companies when each of such companies beneficially owns more than 3 per centum of the outstanding voting securities of the other company. Circular ownership shall be deemed to exist between two companies if such companies are included within a group of three or more companies, each of which --
>
> (1) beneficially owns more than 3 per centum of the outstanding voting securities of one or more other companies of the group; and
>
> (2) has more than 3 per centum of its own outstanding voting securities beneficially owned by another company, or by each of two or more other companies, of the group.

During examinations, a review should be made of the investment company's most current prospectus (in the case of an open-end company) or the most recent Form N-2 filed by a closed-end company, proxy statements and periodic reports, to determine: (1) what the investment company's investment objectives are; (2) what restrictions are imposed on the investment company respecting the types of securities, companies or industries in which it may invest; (3) the percentage of its assets it may commit to a particular type or types of securities; companies or industries; (4) whether it may engage in short selling, margin transactions or similar hedge techniques; (5) whether or not it may lend or borrow money; and (6) what other types of restrictions are set forth.

A review should be made of the investment company's current portfolio positions as well as any positions that may have been closed out during a reasonable period of time (12 months) to determine compliance with any of the company's stated investment policies or statutory limitations. In addition, all other assets and liabilities should be analyzed to determine compliance with such policies and limitations. Assets or liabilities involving affiliated persons or their affiliates, should be carefully reviewed for compliance with Section 17. (See earlier discussion of Section 17.)

During the course of such review, the examiner should pay particular attention to any securities, the salability of which are conditioned, and to obtain full details of any such transactions. The examiner should inquire as to whether any securities have ever been purchased under letters of investment. In the event the investment company did acquire such securities, all pertinent material including agreements or contracts of purchase should be reviewed. If those securities have been disposed of, the circumstances surrounding the sale should be reviewed.

In addition, careful attention should be given to the investment company's acquisition of little known, thinly traded or new issues of securities of doubtful investment merit. 1/ A review of such transactions or any losses incurred in the sale of such securities should result in a detailed inquiry into the investment company's trading and investment policies including a review of internal controls involving such policies as well as identification of the person or persons responsible for such decisions, the quality and quantity of information available to such persons, the broker-dealer involved, and whether or not insiders or affiliated persons had any direct or indirect interest in the issuers, underwriters or the portfolio company itself.

1/ See Appendix I-G-3, Director's Memorandum 72-14, Investment Company Purchases of Securities Having Questionable Investment Merit.

MANAGEMENT FUNCTIONS

8. COMPOSITION OF THE INVESTMENT COMPANY'S BOARD OF DIRECTORS

Section 10(a) of the Act prohibits an investment company from having a board of directors more than 60% of whom are interested persons of the company.

Section 10(b) of the Act prohibits an investment company from:

(1) employing as regular broker any director, officer, or employee of such registered company, or any person of which any such director, officer, or employee is an affiliated person, unless a majority of the board of directors of such registered company shall be persons who are not such brokers or affiliated persons of any of such brokers;

(2) using as a principal underwriter of securities issued by it any director, officer, or employee of such registered company or any person of which any such director, officer, or employee is an interested person, unless a majority of the board of directors of such registered company shall be persons who are not such principal underwriters or interested persons of any of such principal underwriters; or

(3) having as director, officer, or employee any investment banker, or any affiliated person of an investment banker, unless a majority of the board of directors of such registered company shall be persons who are not investment bankers or affiliated persons of any investment banker.

Section 10(c) of the Act prohibits an investment company from having a majority of its board of directors consisting of persons who are officers, directors, or employees of any one bank.

Under limited circumstances, Section 10(d) allows a no-load, open-end investment company to have a higher concentration of interested persons on its board of directors.

An "interested person" is defined by Section 2(a)(19) of the Act. The term includes affiliated persons of an investment company, its investment adviser and principal underwriter, as well as members of the immediate family of such affiliated persons and persons who have beneficial interests or legal interests as fiduciaries in securities issued by the investment adviser, principal underwriter and their controlling persons. The term also includes any broker-dealer registered under the Exchange Act, and any affiliated persons of any such broker-dealer, and legal counsel for an investment company, its investment adviser and principal underwriter and partners, and employees of such legal counsel. In addition, the definition includes any natural person whom the Commission by order shall have determined to be an interested person by reason of having or having had a material business or professional relationship with an investment company, or another investment company having the same investment adviser or principal underwriter, or certain of their affiliates. (See earlier discussion of "affiliated persons".)

Section 16 of the Act requires generally that directors be elected to that office by the holders of the outstanding voting securities of the investment company. Vacancies occurring between shareholder meetings may be filled as long as two-thirds of the board always consists of duly elected directors.

During examinations the composition of the company's board of directors should be reviewed for compliance with Sections 10 and 16. Affiliations of directors can be found in the company's prospectus, registration statements, Forms N-1 or N-2 and proxy statements. Particular attention should be given to all apparent relationships between independent or disinterested directors and the investment company, its chief executive officer, related investment companies, or the investment adviser.

9. INVESTMENT ADVISORY AND PRINCIPAL UNDERWRITING CONTRACTS

Section 15 of the Act requires that investment advisers and principal underwriters to registered investment companies serve only pursuant to written contracts. Section 15(a) requires that investment adviser contracts be approved by the majority of outstanding voting shares of the investment company and that such a contract:

(1) precisely describes all compensation to be paid thereunder; 1/

(2) shall continue in effect for a period more than two years from the date of its execution, only so long as such continuance is specifically approved at least annually by the board of directors or by vote of a majority of the outstanding voting securities of such company;

(3) provides, in substance, that it may be terminated at any time, without the payment of any penalty, by the board of directors of such registered company or by vote of a majority of the outstanding voting securities of such company or not more than sixty days' written notice to the investment adviser; and

(4) provides, in substance, for its automatic termination in the event of its assignment.

Section 15(b) of the Act requires that a principal underwriter contract:

(1) shall continue in effect for a period more than two years from the date of its execution, only so long as such continuance is specifically approved at least annually by the board of directors or by vote of a majority of the outstanding voting securities of such company; and

(2) provides, in substance, for its automatic termination in the event of its assignment.

1/ The term "compensation" also includes "unmentioned" compensation. For example, this form of compensation would refer to a situation whereby an investment adviser was receiving a discount or rebate in the form of research services provided from a broker in exchange for directing a specified or unspecified amount of fund portfolio brokerage to such broker-dealer.

The term "assignment" is defined in Section 2(a)(4) of the Act as follows:

> "Assignment" includes any direct or indirect transfer or hypothecation of a contract or chose in action by the assignor, or of a controlling block of the assignor's outstanding voting securities by a security holder of the assignor, but does not include an assignment of partnership interests incidental to the death or withdrawal of a minority of the members of the partnership having only a minority interest in the partnership business or to the admission to the partnership of one or more members, who, after such admission, shall be only a minority of the members and shall have only a minority interest in the business.

Section 15(c) of the Act states that:

> In addition to the requirements of subsections (a) and (b) of this section, it shall be unlawful for any registered investment company having a board of directors to enter into, renew, or perform any contract or agreement, written or oral, whereby a person undertakes regularly to serve or act as investment adviser of or principal underwriter for such company, unless the terms of such contract or agreement and any renewal thereof have been approved by the vote of a majority of directors, who are not parties to such contract or agreement or interested persons of any such party, cast in person at a meeting called for the purpose of voting on such approval. 1/ It shall be the duty of the directors of a registered investment company to request and evaluate, and the duty of an investment adviser to such company to furnish, such information as may reasonably be necessary to evaluate the terms of any contract whereby a person undertakes regularly to serve or act as investment adviser of such company.

If the investment adviser contract involves a performance fee, Section 205 of the Advisers Act and Rule 205-1 thereunder prohibit all performance fee contracts unless compensation under them increases and decreases proportionately with investment performance of the company over a specified

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1/ To satisfy Section 15 of the Act, directors must be "physically present" to cast their respective votes. Telephonic meetings, although permitted by various state statutes, do not satisfy the "physically present" requirement of Section 15. See Investment Company Act Release No. 6336 which clarifies the scope of the "in person" requirement of Section 15(c).

period in relation to the investment record of an appropriate index of securities prices or such other measure of investment performance as the Commission by rule, regulation or order may specify. 1/ The point from which increases and decreases in compensation are measured must be the fee which is paid or earned when the investment performance of the company is equivalent to that of the index. Rule 205-1 contains further requirements as to the calculation of performance fees.

Advance interim payments of performance fees are considered improper, except when the fee schedule provides for the payment of a minimum fee by the investment company regardless of the performance of the investment company. In such cases the interim payment may not exceed the amount of the minimum fee allocated for the year. Payment of the interim performance fee with a year end adjustment is thus prohibited, but must be distinguished from the so-called "moving twelve" type of performance fee under which a fee is computed and paid quarterly or monthly on the basis of performance over the twelve months preceding each computation. Under this type of fee there is no year end adjustment.

The examination should include a review of all provisions contained in such contracts to determine among other things (1) whether the services stated therein are, in fact, being performed; (2) if either contract provides for the furnishing of office space, other facilities, personnel and the payment of certain expenses of the company, whether such space, facilities, and personnel are, in fact, being furnished, and such expenses paid; (3) whether the advisory fee is being calculated and paid in accordance with its terms; and (4) whether the adviser and underwriter have the facilities to perform all functions required of them under the contracts.

The examiner during his review of the investment advisory contracts, should review the company's general ledger to determine the existence of any receivable due the company from its investment adviser either by reason of an accrued refund of an investment advisory fee or a guarantee of an expense limitation which has become operative. The existence of such receivable raises the question of the financial ability of the adviser to pay the amount due or whether the receivable is, in fact, a loan prohibited by Section 17(a)(3). If the ability of the adviser is questionable a further question may arise with respect to the accuracy of the computation of net asset value. Problems of this type may be particularly prevalent in smaller sized investment companies. 2/

1/ See Appendix I-H-1, Investment Advisers Act Release No. 327, Adoption of Rule 205-1 under the Investment Advisers Act of 1940.

2/ See Appendix I-H-3, Director's Memorandum No. 72-9, Financial Difficulties being Encountered by Investment Advisers and Principal Underwriters to Smaller Sized Investment Companies.

The minutes of the shareholder meetings and directors' meetings and related proxy statements should indicate that such contracts have been properly voted on and renewed as required. The terms of the contracts should be consistent with practices and disclosures, and related expenses should be allocated equitably and as set forth. The information, especially financial presentations, used by the directors to evaluate the terms of the contracts pursuant to Section 15(c) should be reviewed.

A determination should be made, after appropriate inquiry or review, whether or not changes in ownership or control of either the investment adviser or principal underwriter which may have constituted "assignment," have occurred.

If an examiner notes that an investment adviser has been compensated for the sale of its business to a successor investment adviser, inquiry should be made as to whether such sale was in compliance with Section 15(f) of the Act. Section 15(f) of the Act provides, in relevant part, that:

> "(a)n investment adviser . . . of a registered investment company . . . may receive any amount or benefit in connection with a sale of securities of, or a sale of any other interest in such investment adviser . . . which results in an assignment of an investment advisory contract with such company . . ., if (A) for a period of three years fter the time of such action, at least 75 per centum of the members of the board of directors of such registered company . . . (or successors thereto, by recorganization or otherwise) are not (i) interested persons of the investment adviser of such company . . ., or (ii) interested persons of the predecessor investment adviser . . . and (B) there is not imposed an unfair burden on such company as a result of such transaction or any express or implied terms, conditions, or understandings applicable thereto."

The minutes of the shareholder meetings and directors' meetings, investment adviser's directors' minutes and records, and related proxy statements should provide insight to this matter.

In checking for compliance with the various provisions of Section 15, the statute itself can serve as a useful checklist.

10. INDEPENDENT PUBLIC ACCOUNTANTS

Section 32(a) of the Act requires in part that when independent public accountants certify financial statements for registered management investment companies:

(1) such accountant shall have been selected at a meeting held within thirty days before or after the beginning of the fiscal year or before the annual meeting of stockholders in that year by the vote, cast in person, of a majority of those members of the board of directors who are not interested persons of such registered company; 1/

(2) such selection shall have been submitted for ratification or rejection at the next succeeding annual meeting of stockholders if such meeting be held, except that any vacancy occurring between annual meetings, due to the death or resignation of the accountant, may be filled by the vote of a majority of those members of the board of directors who are not interested persons of such registered company, cast in person at a meeting called for the purpose of voting on such action;

(3) the employment of such accountant shall have been conditioned upon the right of the company by vote of a majority of the outstanding voting securities at any meeting called for the purpose to terminate such employment forthwith without any penalty; and

(4) such certificate or report of such accountant shall be addressed both to the board of directors of such registered company and to the security holders thereof.

Section 32(b) prohibits a registered management company or face amount certificate company from filing with the Commission, any financial statement which was prepared in whole or in party by a controller or principal accounting officer or employee of the investment company unless that person was selected either by a vote of a majority of the outstanding voting securities or by the board of directors of the investment company.

1/ See Footnote 1, page 59 as to requiring the "physical presence" of directors to cast their respective votes. Such requirement is also applicable to the selection of accountants in accordance with Section 32(a) of the Act.

During examinations, the minutes of the directors' meetings and the shareholders meetings, as well as related proxy statements to shareholders, should be reviewed and a determination made as to whether the selection of independent accountants was properly made. Generally, independent accountants rendering their opinion on financial statements with the Commission on behalf of a registered investment company must have been selected at a meeting of a majority of those members of the board of directors who are not interested persons of the investment company within thirty days before or after the beginning of the fiscal year or before the annual meeting of stockholders. The selection of the accountants must be ratified by the shareholders at the next annual meeting. The employment of the accountants must be conditioned upon the right of the investment company to terminate its service by a vote of the majority of the outstanding voting securities.

Certifying accountants must meet certain standards of independence. 1/ An important consideration in determining whether an accountant is independent is the relationship between the company, its stockholders, and the accountant. Common financial or business interests, conflicting interests, and family relationships are indications of lack of complete independence. If such circumstances are noted during examinations, they should be carefully reviewed. Moreover, any professional service rendered by the accountant, which is categorized as a non-audit service, should be reviewed to determine the possible effect, if any, on the independence of the accountant. 2/ Any individual tax service accorded by the accountant to an employee, director or officer of the investment company would be an example of a non-audit service.

1/ See Appendices I-J-1 and I-J-2, Investment Company Act Release Nos. 7264 and 10059, Independence of Accountants.

2/ With respect to disclosure in proxy statements relating to audit and non-audit services provided by the accountant, see Schedule 14A, Item 8(g) of the Exchange Act.

11. MEETINGS OF DIRECTORS, SHAREHOLDERS, AND COMMITTEES

Paragraph (b)(4) of Rule 31a-1 under the Act requires that minute books of stockholders' meetings, directors' meetings, directors' committee meetings, and advisory board or advisory committee meetings, be maintained and kept current.

During the examination, a determination should be made by inquiry or otherwise, as to the respective functions of the various groups and committees involved in the investment company's operation, and a listing obtained of the individuals who make up such groups and committees. The minutes of the meetings of these groups and committees should then be carefully reviewed. It is suggested that the review be conducted using a worksheet schedule similar to the one shown below which reflects meetings of an investment company's board of directors. This schedule is prepared directly from the minutes of the meetings and reflects the names of directors, whether they are interested persons, and their attendance at meetings. Poor attendance at meetings by directors may be an indication of non-feasance. In addition to reflecting directors' attendance, the schedule should reflect when directors are elected and when they resign. Significant actions reflected in the minutes should be noted and a brief synopsis of the meetings prepared with particular emphasis on:

A. whether the board of directors is constituted in accordance with the requirements of Section 10 of the Act;

B. whether changes in the board of directors were made in accordance with the requirement of Section 16 of the Act;

C. the approval and continuance of investment advisory and underwriting contracts (Section 15 of the Act);

D. the selection of independant auditors (Section 32 of the Act);

E. with regard to items C and D above, whether the votes by the board on the approval of the advisory contract and the selection of accountants meet the physical presence requirements of Sections 15(c) and 32(a)(1) respectively of the Act

F. the approval of the adequacy of the fidelity bond (Rule 17g-1 under the Act);

G. the valuation of securities (Section 2(a)(41) of the Act);

H. the review made of portfolio transactions, investment decisions and related recommendations;

I. any other matters which the examiner deems of a material nature.

Minutes of the meetings of the investment company's directors' committees and advisory board or advisory committees should also be carefully reviewed and schedules similar to the following prepared. If minutes of meetings held for the purpose of authorizing portfolio transactions are not kept, review records maintained to reflect such authorization pursuant to Rule 31a-1(b)(10).

When reviewing the minutes of directors' meetings, as well as during other phases of the examination, particular attention should be paid to the manner in which those directors who are not "interested persons" (independent directors) perform their functions. 1/

The minutes of the shareholder meetings are usually filed with the minutes of the board meetings. These should also be examined carefully and action on all statutory items noted. The proxy statement relative to the most recent shareholder meeting should be reviewed at this time to see that all important matters voted on at the meeting were described in the proxy statement.

1/ See Appendix I-I-1, Duties of the Independent Director in Open-End Mutual Funds.

WORKSHEET FOR REVIEW

OF

MEETINGS OF THE BOARD OF DIRECTORS

Name of Director	Date of Meeting											
	1981										1980	
	10/28/81	9/25	8/20	7/26	6/30	5/25	4/24	3/30	2/17	1/25	12/24/80	11/28
Adams	x	o	o	x	x	x	x	x	x	x	x	x
Baker*	x	x	x	x	x	o	x	x	x	x	x	x
Howard	x	x	x	x	x	x	x	x	x	x	x	x
Mason*	x	x	x	x	x	x	x	o	x	x	x	x
Smith*	x	x	x	x	x	x	x	x	x	x	x	x
Traynor	x	x	o	x	x	x	x	x	o	x	x	x
Whitney	x	x	x	x	x	x	x	x	x	elected	-	-
Blake										resigned	x	x

General Notes

1. Portfolio Transactions occuring between meetings reviewed and ratified.
2. Howard usually dominates discussion.
3. All decisions unanimous.

x - Denotes Present at meeting
o - Denotes Absence from meeting

Specific Notes

9/25/81 Fidelity coverage reviewed and approved.

7/26/81 Independent accountants approved (for submission to shareholders)
Advisory contract continued (for submission to shareholders)
Distribution contract continued (for submission to shareholders)
Present directors nominated (for submission to shareholders

1/25/81 Blake resigns (bad health)

12. CORRESPONDENCE

Paragraph (a)(2) of Rule 31a-2 requires that correspondence of registered investment companies, and certain other persons having transactions with registered investment companies, be preserved for at least six years, the first two years in an easily accessible place.

During the examination, an inquiry should be made as to the manner in which various types of correspondence are handled and filed. The various categories of correspondents may include potential investors, shareholders, broker-dealers who sell shares of the investment company, broker-dealers who execute portfolio transactions for the investment company, regulatory or self-regulatory bodies, issuers or persons connected with issuers of portfolio securities, and persons transacting business with the investment company such as banks, printers, attorneys, accountants, and suppliers. The inquiry should enable the examiner to determine the location of the various types of correspondence. For example what correspondence is maintained by the investment company, the investment adviser, custodian, service agent, and principal underwriter.

The examiner should determine after appropriate inquiry, observation, or both, whether any unusual delays are being encountered in answering investor and shareholder correspondence. If any indications of a significant backlog of unanswered correspondence are noted, a careful analysis of the circumstances involved should be made.

The examiner should also review any correspondence that may be kept in the advisory or research files of the investment company or its investment adviser, including material received from broker-dealers or other institutions which execute transactions for the investment company and furnish research reports.

13. FIDELITY COVERAGE

Rule 17g-1 under the Act requires that officers and employees of registered management investment companies who may singly or jointly with others have access either directly or indirectly, to securities or funds of an investment company, be bonded against larceny and embezzlement. The bond may be in the form of (1) an individual bond for each covered person, (2) a "single insured bond" which names the investment company as the only insured, or (3) a "joint insured bond" which names the investment company and one or more parties as insureds.

During the examination, the minutes of the investment company's board of directors meetings should be carefully reviewed to determine if the directors exercised their statutory responsibilities under the Rule and their general fiduciary obligations under the Act. The examiner should pay particular attention, in this respect, to paragraphs (d) and (e) of the Rule.

Paragraph (d) states that the bond shall be in such reasonable form and amount as a majority of the board of directors of the investment company who are not interested persons ("disinterested directors") of such investment company shall approve as often as their fiduciary duties require, but not less than once every twelve months. The examiner should determine by reviewing the minutes of the directors' meetings, if the factors set forth in paragraph (d) were utilized by the directors in their review of the investment company's bond.

Paragraph (e) of the Rule states that a majority of the disinterested directors of each investment company named as an insured in a joint insured bond should approve the portion of the premium to be paid by each such company, taking all relevant factors into consideration. The examiner should review the minutes of the board of directors' meetings to ascertain if the relevant factors as set forth in, but not limited to, paragraph (e) of the Rule were considered by the directors in their review of the premium payment to be paid by the investment company.

When reviewing both the minutes of the directors meetings and the fidelity bond, an examiner should be aware of the views of the Division of Investment Management ("Division") regarding the duties of disinterested directors as set forth in Commission Release No. IC-10393. 1/ This release highlights two specific areas of concern which the disinterested directors should focus on while reviewing the fidelity coverage of an investment company, namely, the "trading loss exclusion" and the definition of "employee" which exists in certain types of fidelity bonds currently in use in the investment company industry. The release in essence reflects the Division's opinion that it is vitally important that there be no exclusion in investment company indemnity bonds for losses resulting from dishonest or fraudulent portfolio trading by any of its officers and employees, committed directly or in collusion with others.

The examiner should review the bond to see if there is any type of deductible feature from the face amount of the bond as it is the Division's

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1/ See Appendix I-K-1, Investment Company Act Release No. 10393, Fidelity Bonding of Registered Management Investment Companies.

view that a provision in a fidelity bond which provides for a deductible from the amount of coverage provided is not consistent with Rule 17g-1. 1/

The examiner should review the amount of the fidelity bond coverage in accordance with the schedule set forth in paragraph (d) of the Rule, which gives the minimum amount of coverage for a given amount of investment company gross assets. The examiner should also obtain proof that the fidelity bond is in effect. Such proof should be in the form of an identifiable voucher or bill showing the time period for the fidelity bond and the cost and a cancelled check proving payment.

The examiner should give particular attention in his review of the fidelity bond with respect to paragraph (c) of the Rule, which requires that in the case of an individual bond or single insured bond, written notice be given by the acting party to the affected party and to the Commission not less than 60 days prior to the effective date of cancellation, termination, or modification of the bond. With respect to a joint insured bond, written notice should also be given by the acting party to the affected party and by the insurance company to each named investment company in the bond and the Commission not less than 60 days prior to the effective date of cancellation, termination, or modification. Where a bond has been canceled, terminated or modified the examiner should inquire and analyze the causes for such action.

If the investment company is one of several entities in a joint insured bond, the examiner should review the bond to see if the other parties in the bond are permitted entities as set forth in paragraph (b) of the Rule. The examiner should also ascertain if agreements have been entered into between each registered investment company named as an insured and all of the other named insureds in the bond, as required by paragraph (f) of the Rule. The examiner should further determine if these agreements comply with paragraph (f) of the Rule, in that it should be provided that a minimum recovery under the bond by an investment company be at least equal to the amount which it would have received had it been insured under a single insured bond with the minimum coverage required by paragraph (d)(1) of the Rule. Also, the examiner should carefully review the manner in which the premiums are allocated amongst the parties to ascertain that no party is bearing a disproportionate amount of the premium or being unduly advantaged.

During the examination, a determination should be made if proper and timely filings with the Commission were made by the investment company,

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1/ The staff has permitted a deductible feature, subject to various conditions as set forth in its favorable no-action reply to Adams Fiduciary Bond Fund (June 6, 1980). In general, the amount of the deductible is placed in an escrow account by the investment adviser. This enables a fund to be repaid in full (including the deductible) in the event of a loss covered by the fidelity bond.

as required by paragraph (g) of the Rule. The examiner should also inquire as to the identity of the officer designated to make such filings as required by paragraph (h) of the Rule.

Errors and Omissions Insurance Policies

In addition to the statutory fidelity bond required by Section 17 of the Act, many investment companies have voluntarily elected to maintain an "errors and omissions" insurance policy. Such coverage is sought, at least in part, in order to attract qualified persons to serve as directors and officers of investment companies.

The examiner, in reviewing insurance policies of an investment company, other than the fidelity bond coverage required by Section 17(g) and Rule 17(g)-1 thereunder, should be particularly aware of the following possible violations of the Act and Rules, and structure his examination accordingly:

(1) The examiner should ascertain if any violations of Section 17(d) of the Act have occurred. Violations of Section 17(d) would occur if the investment company has entered into a joint agreement with any affiliates, including its investment adviser, and bears the complete cost for the payment of insurance premiums or the joint coverage of directors and officers of the investment company and the affiliate. 1/

(2) The examiner should determine if a violation of Section 17(h) of the Act has occurred. Section 17(h) provides that a director or officer of the investment company may not be protected against any liability to a registered investment company or its security holders to which he would otherwise be subject by reason of his willful misfeasance, bad faith, gross negligence or reckless disregard of the duties involved in the conduct of his office. An insurance policy which is paid for by the investment company covering any of the above-mentioned categories would be in violation of Section 17(h) ". . . unless it merely provided for payment to the registrant of any damages caused by a director or officer, and also provided that the insurance company would be subrogated to the rights of the registrant to recover from the director or officer." 2/

1/ There is a proposed amendment to Rule 17d-1 to allow investment companies to purchase this type of liability insurance policy with certain affiliated persons. See Release No. IC-10700, "Exemption of Certain Joint Purchasers of Liability Insurance Policies" (May 16, 1979).

2/ See Appendix I-B-2, Investment Company Act Release No. 7221, Guidelines to Form N-8B-1. The guidelines go on to state that "There would be no objection, however, to insurance policies which were paid for by the directors or officers themselves covering liabilities arising from the enumerated categories or activities." Also, see Investment Company Act Release No. 11330, staff position on indemnification by investment companies.

14. Activities of Affiliated Persons

As noted earlier, affiliated persons of an investment company and its investment adviser are severely restricted from engaging in transactions in securities which are held by, or about to be acquired by, the affiliated person or investment company. Specific provisions relating to such restrictions appear in Section 10(f), 17(a), 17(d), and 17(e) of the Act and Rules thereunder, as well as Section 36 of the Act and anti-fraud provisions of other Federal securities laws and regulations. With the outgrowth of "re-regulation" in 1979 and 1980, several changes have occurred which reemphasized the responsibility and duties of the board of directors to investment companies. This has also resulted in several rule changes under the Act which now permit greater flexibility to transactions involving affiliated persons and investment companies. To assist the examiner, the following list represents an overview of transactions which are specifically exempt from Section 17 of the Act. No attempt has been made to restate the Act. Accordingly, each examiner is referred to the appropriate Section and Rule thereunder for a more complete presentation.

1. Rule 17a-1 exempts certain underwriting transactions which are exempted by Rule 10f-1.

2. Rule 17a-2 exempts certain transactions with banks involving notes, drafts, time payment contracts, bills of exchange, acceptance or other property of a commercial character rather than of an investment character.

3. Rule 17a-3 exempts certain transactions between and amongst investment companies and their fully-owned subsidiaries.

4. Rule 17a-4 provides an exemption for transactions pursuant to a contract if at the time of the contract and for a period of six months prior thereto, no affiliation or other relationship existed which would operate to make such contract or the subsequent performance thereof subject to the provisions of Section 17(a).

5. Rule 17a-5 permits pro rata distributions in cash or kind by an investment company among its shareholders without giving an election to any stockholder as to specific assets to be received.

6. Rule 17a-6 permits an investment company to engage in transactions with an affiliated company or person(s). There are, however, several restrictions in the rule as to person(s) which tend to limit the extent of affiliated participation in such transactions.

7. Rule 17a-7, subject to certain limitations, permits the sale or purchase of securities amongst affiliated investment companies and affiliated persons.

8. Rule 17a-8 exempts mergers, consolidations or sales of substantially all the assets between or among affiliated investment companies having a common investment adviser, common directors, and/or common officers.

9. Rule 17d-1 permits certain "joint" transactions (e.g. joint enterprises or arrangements and certain profit sharing plans) between an investment company and its affiliated persons.

10. Rule 17e-1 further describes "usual and customary broker's commission" as it relates to affiliated brokerage transactions under Section 17(e)(2)(A) of the Act.

Although the foregoing exemptions permit greater flexibility in the financial dealings of investment companies and their affiliates, it causes the board of directors to be more responsible for monitoring such transactions. In turn, the scope of an examination is increased because an examiner will have to review such transactions in their entirety, and the action or inaction taken by the board of directors in each instance. This will cause the examiner to review all documentation and memoranda which was used by the board of directors in arriving at their decisions. Failure to properly document such transactions may be in contravention of the applicable exemption. In reviewing past transactions, the examiner, unlike the board of directors, will have the advantage of "historical hindsight." Please use discretion in attempting to objectively evaluate these past transactions. It is suggested that any criticism of past affiliated transactions be done through the guidance and direction of the Branch Chief.

Finally, the manner in which the investment company (or its investment adviser) monitors the trading activities of affiliated persons should be carefully reviewed during the examination. 1/ A copy of the "code of ethics" adopted by the company should be obtained and examined against actual practice. In addition, the examiner should review the personal security transactions filed by the investment adviser and its advisory representatives pursuant to Rule 204-2(a)(12) of the Advisers Act and compare such transactions with the investment company's portfolio transactions for evidence of "scalping" or other possible violations.

1/ On May 1, 1980, Rule 17j-1 of the Act went into effect. This rule requires every registered investment company and its investment adviser to adopt a written code of ethics governing the trading activities of "access persons" as fefined by the rule. To assist in determining compliance with Rule 17j-1 of the Act, please refer to the rule which will serve as a useful checklist.

15. Custodian Problems and Relationships

Section 17(f) of the Act and the Rules thereunder require every registered management investment company to place and maintain its securities and similar investments under the custody of one of the following:

a) A company that is a member of a national securities exchange as defined in the Exchange Act, subject to the provisions of Rule 17f-1 under the Act;

b) An investment company acting as its own custodian, subject to the provisions of Rule 17f-2 under the Act;

c) A securities depository, subject to the provisions of Rule 17f-4 under the Act; or

d) A bank or banks qualified under paragraph (1) of Section 26(a) of the Act also known as a "true custodianship."

It cannot be emphasized strongly enough that an examiner should review carefully the major operating provisions contained in custodian agreements. Such provisions include, among other things, procedures relating to the receipt and delivery of investment company portfolio securities, and the execution and transmittal to the company's custodian of written authorizations by investment company personnel. Most custodian agreements, generally, require securities purchased to be received by the custodian only against payment therefor, and securities sold are delivered only against the receipt of proper funds. With respect to written authorizations, the signature of two authorized persons is usually required.

An examiner should review the bills and receipts to the investment company from the custodian to determine that the services provided by the custodian and expenses incurred are consistent with the custodian agreement. Any documentation of the board of directors or fund management, which relates to their periodic evaluation of the services and fees under the custodian agreement, should be reviewed. Failure to monitor the fund's custodian services and expenditures on the part of management or the board of directors should be cited in the inspection report.

In addition, it is suggested that the custodian agreement be compared to the model custodian agreement set forth in Appendix I-B-2 to ascertain whether the minimum requirements are contained in the existing agreement(s).

1) A Member of a National Securities Exchange as Custodian

Whenever an investment company elects to appoint a member of a national securities exchange as a custodian, such arrangement should be evidenced by a written contract between the parties as required by Rule 17f-1 under the Act. The contract should require the investment company's securities and investments be maintained in accordance with the following:

a) All securities and similar investments held in such custody shall, at all times, be individually segregated from the securities and investments of any other person and marked in such a manner as to clearly identify them as the property of such investment company.

b) Broker-dealers shall have no power or authority to assign, hypothecate, pledge or otherwise dispose of any such securities, except pursuant to the direction of such investment company.

c) All securities and investments shall be verified by actual examination at the end of each annual and semi-annual fiscal period by an independent accountant retained by the investment company and shall be examined by such accountant at least one other time, chosen by him, during the fiscal year.

Examinations of investment companies with this type of custodianship may uncover that broker-dealers sometime fail to segregate the assets of investment companies from those of its other clients. Specifically, commercial paper held for these investment companies may be commingled with commercial paper belonging to other broker-dealer clients or proprietory accounts. Examiners should ensure that all provisions of the Rule are being complied with. An examiner may also find it necessary to physically inspect the investment company's securities in order to ascertain complaince with Rule 17f-1.

2) An Investment Company Acting As Its Own Custodian

An investment company may act as its own custodian so long as it does so in accordance with the provision of Rule 17f-2 unde the Act. In essence, the Rule requires:

a) Investments be maintained by such investment company at a bank or other company whose functions and physical facilities are supervised by Federal or State authority under

any arrangement whereunder the directors, officer, employees or agents of such investment company are authorized or permitted to withdraw such investments upon mere receipt.

b) Investments which are deposited in the safekeeping of, or in a vault or other depository maintained by a bank, be physically segregated at all time from those of any other person and shall be withdrawn only in connection with an authorized transaction.

c) No person shall be authorized or permitted to have access to the securities so deposited except pursuant to a resolution of the board of directors of such investment company.

d) Securities and similar investments shall be verified by complete examination by an independent public account retained by the investment company at least three times during each fiscal year, at least two of which shall be chosen by such accountant without prior notice to such investment company.

An examiner should systematically follow all the provisions of this Rule when reviewing the custody arrangements. The examiner may also find it necessary to physically inspect the investment company's securities in order to ascertain compliance with the Rule.

3) Securities Depositories

Rule 17f-4 under the Act provides that all, or any part, of the securities of a registered management investment company may be maintained in a securities depository.

A securities depository is essentially a system for the central handling of securities where all securities of any particular class or series of any issuer deposited within the system are treated as fungible and may be transferred or pledged by bookkeeping entry without physcial delivery of the securities. When examining an investment company which uses a securities depository, it is incumbent upon an examiner to satisfy himself that the following elements are present:

a) The investment company has a system to prevent unauthorized officer's instructions. It should provide, at least, for the form, content, and means of giving, recording, and reviewing the instructions.

b) Provisions exist so that upon ceasing to act for an investment company, any such agency shall

deliver all securities held for the investment company to a successory agency or other qualified entity so named by the investment company.

c) The investment company, by resolution of its board of directors, has approved the arrangement, and it is reviewed at least annually. In the original approval by the board of directors, careful consideration should have been given to the terms of any such depository arrangement, the technical capability of the parties to discharge their responsibilities, the costs and risks involved, any other pertinent factors that relate to the safety, or cost effectiveness of the arrangement.

Often times a qualified custodian may deposit investment company securities in a securities depository of which it is a participant. In this instance, the custodian may deposit the securities directly or through one or more agents which are also qualified to act as a custodian for an investment company. When encountering this arrangement, the examiner must ensure that the custodian or its agents are required to deposit the securities in a non-proprietary accounts which include only assets held for customers, making appropriate provision with respect to such matters as the earmarking, segregation, and hypothecation of these securities. 1/ The examiner should satisfy himself that the custodian sends the investment company a confirmation of any transfers to or from the account of the investment company and where securities are transferred to that account, that the custodian, by book entry or otherwise, identifies as belonging to the investment company a quantity of securities in a fungible bulk (i) registered in the name of the custodian (or its nominee) or (ii) shown on the custodian's account on the books of the clearing agency, the book entry system, or the custodian's agent.

An examiner should always review the investment company's files in order to ascertain if the custodian, or its agent which deposits the securities, promptly sends to the investment company reports it receives from the appropriate Federal Reserve Bank or clearing agency on its system of internal accounting control and that, the custodian and all agents through which the securities are deposited sends to the investment company such reports on their own systems of internal accounting control when requested to do so. And, of course, the examiner should review the minutes of the board of directors meetings in order to determine that the investment company's participation in any such arrangement is pursuant to board of directors's resolution, and is reviewed at least annually.

1/ A non-proprietary account refers to an account where the exclusive right of ownership rests with the customer and not the bank or entity which oversees such account.

4) A Bank as Custodian

The most common type of custody arrangement is that between an investment company and a bank. This arrangement is formalized in an agreement which essentially calls for written instructions prepared by a designated officer or officers to be sent to such bank prior to settlement of the investment company's portfolio transactions as well as prior to the disbursements of any monies by the Custodian. Generally, custodian agreements explicitly call for payment only upon delivery of portfolio securities purchased and delivery of securities sold only against receipt of payment. These agreements further require that the names and signatures of those persons authorized by the board of directors to sign written instructions be filed with the custodian bank, and that the custodian be notified of any changes with respect to such authorized persons.

An examiner should be aware that the majority of investment companies maintain their portfolio securities with a bank pursuant to a custody agreement conforming substantially to the provisions in the model agreement set forth in Investment Company Act Release No. 7221 (See Appendix I-B-2). However, because of recent developments in the securities markets both custodian banks and investment companies circumvent some of the basic provisions contained in their agreements. Because these agreements require instructions to be signed by a designated officer or officers and that these instructions be presented to the custodian prior to all settlements of portfolio transactions, they have caused a problem of logistics for those investment companies who trade money market instruments. Since these instruments normally settle on the same day as the trade date, investment companies have found it inconvenient to get the proper authorizations signed and delivered to their custodian before the transactions have settled. An agreement is being adhered to by simply reviewing the written instructions received by the custodian bank. Instructions should never be date stamped on a retroactive basis by the custodian as having been received prior to or on the settlement date of a transaction.

An examiner should always review the signatories on officers' certificates for verification that the custodian bank is honoring only those certificates signed by people who are so authorized by the investment company's board of directors. If two authorized signatures are required, an examiner should make sure the instructions are properly signed.

The examiner should obtain by inquiry or otherwise, information as to any "redeposits" or cash balances which the custodian or any other depository of the investment company is maintaining with other banks on behalf of the investment company or affiliated persons. A complete description of the circumstances surrounding such arrangements should be gathered. Also, a detailed inquiry should be made into the reasons and circumstances involving any large amounts of uninvested cash.

If the investment company maintains its own cash accounts, whether or not a true custodianship exists, such accounts should be independently reconciled by the examiner or a recent reconcilement by the investment company should be reviewed. Checks drawn against the account should be reviewed for propriety. A review should also be made to insure that such disbursements are adequately supported by invoices, vouchers or bills. Periodic statements of the cash account, which were mailed to the investment company are prepared by the depository, should be in the investment company's files. These statements should be reviewed, at least on a limited basis, against reconcilements of those statements, which should be made by the company at least monthly, and against the cash receipts and disbursements detailed records.

With respect to checking accounts, Section 17(f) of the Act requires that the cash balances in such accounts shall at no time exceed the amount of the fidelity bond maintained pursuant to Section 17(g) and Rule 17g-1 thereunder, covering the officers and employees of the investment company authorized to draw on such accounts. An examiner should always make it a practice to review checking account balances, not only at month end, but at interim times within a month.

SALES AND LIQUIDATIONS OF INVESTMENT COMPANY'S SHARES

16. DISTRIBUTION AND REPURCHASE OF CLOSE-END INVESTMENT COMPANY SHARES

Section 23 of the Act and the Rules thereunder prohibit a registered closed-end company from issuing its securities for services or for property other than cash or securities except as a dividend or distribution to its security holders or in connection with a reorganization. The company may not sell any stock of which it is the issuer at a price below the current net asset value of the stock exclusive of distributing commission or discount except in connection with an offering to the holders of a class of capital stock with the consent of a majority of its common stockholders, or upon conversion of a convertible security.

A registered closed-end company can purchase its own securities on the open market provided that if the purchase is of stock, the company within the preceding six months must have informed its stockholders of such purchase. Additionally, it can purchase its securities by tender offer given to all holders of the class to be purchased. Rule 23c-1 lists the conditions under which the company may repurchase its securities. Rule 23c-1 lists the conditions under which the company may call and redeem its securities.

During examinations of closed-end investment companies, an inquiry should be made as to whether securities issued by the company have been sold or purchased by the company and whether or not such sales or repurchases are contemplated. A review of the general ledger, particularly the cash and capital accounts, may disclose indications of such activity. The minutes of the company's directors' meetings may also disclose such indications.

Where such activity is noted, a detailed review should be made of the circumstances surrounding the transactions. Using published copies of the Investment Company Act and the Rules thereunder as check-lists, determine whether the provisions of Section 23 and Rules 23c-1 and 23c-2 were complied with. Check also into the methods used by the company to inform existing shareholders of their intention to repurchase.

17. SALES OF OPEN-END INVESTMENT COMPANY SHARES

Section 22(d) of the Act and the Rules thereunder specify certain requirements applicable to the sale of open-end investment company shares. Generally, sales of such shares must be at the public offering price described in the prospectus. Pursuant to Rule 22c-1 the public offering price must be based on the current net asset value of the shares as next computed after the receipt of the order. 1/ The Rule further requires that the price be computed at least once each day as of the close of the New York Stock Exchange. The time of receipt of the order by the retailing dealer is considered to be controlling. 2/

Other Federal Securities Laws and Regulations applicable to the distribution of open-end investment company shares which should be reviewed for compliance during investment company examinations where feasible, include:

a. Section 11(b)(1) of the Exchange Act which prohibits the extension of credit by a dealer on a security which is part of a new issue, and in which he is participating in the distribution of.

1/ See Appendix I-L-2, Investment Company Act Release No. 5519, Adoption of Rule 22c-1.

2/ See Appendix I-L-3, Investment Company Act Release No. 5569, Staff Interpretive Positions Relating to Rule 22c-1.

b. Regulation R promulgated by the Board of Governors of the Federal Reserve System which requires that broker-dealers liquidate or cancel cash securities purchases by customers if payment is not received within seven business days. The Regulation also prohibits release of proceeds of sales of securities to cash customers until the securities which have been sold have been paid for in full.

c. Rule 15e2-4 under the Exchange Act which requires that monies received by any broker-dealer participating in distributions of new issues, other than firm commitment underwritings, be promptly transmitted to the persons entitled thereto.

d. The Commission's Statement of Policy which sets forth advertising and sales literature standards in connection with investment company shares. 1/

e. Section 11 of the Act which requires that offers of exchange involving open-end shares be based on relative net asset values.

1/ See Appendix I-B-5, which relates to the withdrawal by the Commission of its Statement of Policy on investment company sales literature and the adoption of Rule 156 under the Securities Act.

f. Rule 12b-1 under ther Act which pertains to the distribution of shares of open-end investment companies and related expenses thereto. 1/

g. Section 22(g) of the Act which prohibits open-end companies from issuing shares for services or for property other than cash.

During examinations of open-end investment companies, inquiry should be made as to how the company's shares are distributed. Note whether shares are retailed by the company itself, retailed or wholesaled by the principal underwriter, retailed by affiliated broker-dealers (captive sales force), or retailed by independent broker-dealers. Of particular interest is to what extent, if any, the investment company bears any advertising or distribution costs in the sale of its shares. The manner of allocating such expenses must be consistent with the investment company's contractual arrangements to sell its shares and in compliance with the Act on the use of fund assets to bear such costs. 2/ With respect to prospectus expenditures, whether such

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1/ Rule 12b-1 under the Act permits an open-end investment company, acting as its own distributor, to participate in the distribution of its shares and financial expenditures therewith. Such participation must be pursuant to a formal written plan or agreement 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. To implement or continue a plan of participation, the directors have the duty to request and evaluate such information as may reasonably be necessary to make an informed determination. All pertinent factors considered by the directors and the basis for their decision should be described in the minutes and preserved in accordance with Rule 12b-1(f) of the Act. See Appendices I-L-5 and I-L-6, Investment Company Act Release Nos. 10862 and 11414.

2/ Ibid.

costs fall solely within the category of "sales or promotional" expenses is subject to question. Whether an investment company is a load or no-load fund, there has been no objection to a fund bearing the costs of qualifying its shares for sale under either blue sky laws or the Securities Act. Nor is there any objection to the use of fund assets to pay the cost of preparing, printing and mailing prospectuses to existing shareholders if the fund's Board of Directors has determined that such a practice is consistent with the fund's policy and an appropriate fund expense. However, the incremental costs of printing and distributing prospectuses to interested or prospective investors continues, in the case of both load and no-load funds, to be deemed a sales or promotional expense.

The examiner should inquire as to how "conventional" orders for shares are transmitted from the investor, through the dealer to the principal underwriter and to the investment company, its custodian, and its transfer agent. 1/ (Voluntary and contractual

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1/ Many investment companies and their investment advisers have opted to have a transfer agent perform most of the administrative and recordkeeping duties associated with the purchase and sale of fund shares. Inquiry should be made of the transfer agent as to the extent of its activities and its relation to the investment company and investment adviser. Functions which are customarily performed by the transfer agent include the processing and recordkeeping of purchases and sales on fund shares, handling of correspondence and inquiries related to the fund and its accounts, and so forth. The relation between the investment company, investment adviser and the transfer agent is of particular interest. When the transfer agent is affiliated with the investment adviser, the examiner should determine that the services and duties being performed are legitimate transfer agent functions. Whether or not the transfer agent is affiliated, an examiner should also determine that the services being provided and paid for are in conformance with the contractual agreement between the investment company and its transfer agent. Finally, it should be remembered that the cost attributable to the activities of a transfer agent is an operating expense of the fund which deserves continual review by the board of directors and management. The examiner should request and review any material provided to the board of directors which has enabled them to evaluate the costs and services performed. Whether or not the transfer agent is affiliated, the board of directors has an obligation to determine that the costs and services of the transfer agent are sufficient to meet the fund's needs, and are both competitive and comparable to other transfer agents. Failure to monitor this expense should be cited in the report of examination and the deficiency letter to the registrant.

plan orders should be reviewed along the procedures described in Items 19 and 20 of the Manual and the Outline). A determination should be made as to when and in what manner the investment company is advised of sales; what written notifications are received by it (obtain specimen copies); what effect is given to such transactions in price make-up computations; and when and in what manner details are recorded on the company's books.

A review should be made of sales received from the underwriter to determine whether sales, including those involving quantity discounts, were effected in accordance with Rule 22c-1 and at the public offering prices as represented in the prospectus. Inquiry should be made of any deviations therefrom. On quantity discounts the sales price can be easily checked by dividing the proper net asset value per share by the remainder of (1 minus the discount). For example, if a particular discount transaction calls for a reduced sales load of 2% and the proper net asset value for that transaction was $11.76, then the selling price should be $12.00 or (11.76 - .98).

A review of the investment company's prospectus should be made to determine the accuracy and adequacy of disclosures as to the prospectus for establishing the time that prices become effective for the purchase of shares and also check to insure that such procedures are consistent with Rule 22c-1. Copies of sales literature prepared by the investment company organization should be reviewed to determine whether such material is false or misleading. Where the entity is an NASD member, check that such materials are filed with the NASD. A determination should be made as to what the procedures are with respect to the receipt of payment for shares sold through dealers and with respect to the issuance of such shares, i.e.:

(1) Do the dealers transmit payment for the shares (less their share of the sales load) and the transfer instructions to the principal underwriter, the company or the custodian?

(2) If the transmittals are made by the dealers to the principal underwriter, does the latter advise the company thereof and, in that event, when and in what manner is the company advised and when and in what manner does the company make entries on its books?

(3) If the transmittals are made by the dealers to the custodian, when and in what manner does the latter advise the company of their receipt and with respect to the disposition of the money and the transfer instructions, when and in what detail does the company make the related entries on its books?

An inquiry should be made into the procedures followed with respect to cancellations of sales and delays in payment for shares sold. 1/ In this connection if the review of open share transactions made during the check of the net asset value calculation, revealed stale or outdated items, note whether any potential losses to the company on such sales are indicated. Inquire as to how the company intends to handle such losses and how such losses have been handled in the past. Investment companies should not bear such losses.

If retail sales of shares are made directly by the investment company or by an affiliated broker-dealer, review sales practices. Check sales and promotional materials used by salesmen. Also observe whether or not any improper sales practices such as "selling dividends" are being employed. Check also into any indications of improper extensions of credit or arrangements for loans.

Check into any transactions in which the investment company issued shares at other than the public offering price and for other than cash such as for the acquisition of the assets of another entity. Inquire as to whether a Commission order for exemption was granted in connection with the transaction.

Where shares are exchangeable for shares of other open-end investment companies, check that such exchanges are made on the basis of relative net asset values.

1/ See Appendix I-L-4, Investment Company Act Release No. 6366, Dilution of Net Asset Value and Inappropriate Extensions of Credit in Connection with Sales, Redemptions, and Repurchases of Mutual Fund Shares. Also, see Appendix I-L-7, No-Action Letter as to Delaying Redemption Payments.

Finally, an examiner should inquire as to the current status of the investment company's inventory of registered shares which are available for sale to the public. For guidance in the procedures for registering a definite or indefinite number of shares under both the Securities Act and the Act, see Rules 24e-2 and 24f-2, of the Act. As part of this inquiry, an examiner should verify the status of an investment company's registered shares and reconcile them to its financial statements.

18. LIQUIDATIONS OF OPEN-END INVESTMENT COMPANY SHARES

Section 22(e) of the Act and the Rules thereunder specify certain requirements applicable to the liquidation of open-end investment company shares. Section 22(e) requires generally that proceeds for liquidation of redeemable shares must be transmitted within 7 calendar days after the shares are properly tendered. Liquidations may be suspended only by Commission order, or during periods in which the New York Stock Exchange is closed or in which trading on that Exchange is restricted.

Rule 22c-1 under the Act requires that shares be liquidated at a price based on the net asset value next calculated after receipt of the order or proper tender. 1,2/ The Rule further requires that the price be computed at least once each day as of the close of the New York Stock Exchange.

During examinations of open-end investment companies, a detailed inquiry and careful review should be made as to the manner in which "conventional" share liquidations are processed. (Voluntary and contractual plan liquidations should be reviewed along the procedures discussed in Item 19 and 20 of the Manual and the Outline).

Note whether the company distinquished liquidation procedures between "repurchases" and "redemptions." Some investment companies will make liquidations effective for purposes of pricing upon receipt of the order for such liquidation. The actual payment of proceeds by the fund in such cases (sometimes referred

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1/ See Appendix I-L-2, Investment Company Act Release No. 5519, Adoption of Rule 22c-1.

2/ See Appendix I-L-3, Investment Company Act Release No. 5569, Staff Interpretive Positions Relating to Rule 22c-1.

to as "repurchases" or voluntary repurchase arrangements) should not be made until the certificates are received in proper order from the investor. Other investment companies will not even consider an order for liquidation, even for pricing purposes, until the certificates and all documentation are received and in proper order. Some investment companies have also adopted procedures for liquidating an investor's account which falls below a certain minimum (mandatory or involuntary redemptions). The examiner should determine that the procedure for notification in such instances are being properly followed and application of such procedures consistently applied.

The examiner should determine how orders for liquidation are transmitted from shareholders to the investment company. Inquire as to how notice is given to the investment company's custodian and transfer agent, and how payment is transmitted to the shareholder.

A review should be made of recent liquidations to determine whether or not they were processed in accordance with prospectus disclosure and the applicable provisions of Rule 22c-1. The review should include a check for compliance with Section 22(e) which requires that payment be transmitted within seven days. A worksheet similar to the one appearing on Page 87 can be used in reviewing liquidations. In connection with prospectus disclosure, it is extremely important that a determination be made as to whether such disclosures are adequate as well as being accurate.

If the investment company accepts "repurchase" orders of the type described earlier, a review should be made of the company's methods of handling losses on such transactions resulting from the failure of liquidating shareholders to consummate the transactions by making proper tender. 1/ In this connection, if the review of open share transactions made during the check of the net asset value calculation revealed any stale or outdated items, note whether any potential losses on such items are indicated. Inquire as to how the company intends to handle such losses and how such losses were handled in the past. Investment Companies should not bear such losses.

1/ See Appendix I-L-4, Investment Company Act Release No. 6366, Dilution of Net Asset Value and Inappropriate Extensions of Credit in Connection with Sales, Redemptions, and Repurchases of Mutual Fund Shares.

WORKSHEET FOR REVIEW OF SALES AND LIQUIDATIONS OF FUND SHARES

Trade Date	Name of Investor	Dealer	No. of Shares Bot Liquidated	Price to Customer	Cost or Proceeds	Day Order Received	Time Order Received 1/
5/20/68	J. A. Mason	Eastman Dillon	100	12.13	1,213.00	5/20/68	2:56
5/20/68	J. A. Jones	Hayden Stone	1,000	12.01	12,010.00	5/20/68	2:13 25 m Letter of Intent
5/20/68	Wm. A. Smith	MLPFS	100	10.93	1,089.00	5/20/68	2:22

1/ This column may be further subdivided to show the time that an order was received by a dealer other than a principal underwriter. The extent of delay between any intermediary and the principal underwriter or representative of the fund may warrant further inwuiry.

19. VOLUNTARY PLANS FOR THE PURCHASE, ACCUMULATION, OR HOLDING OF INVESTMENT COMPANY SHARES (INCLUDING ALL SERVICE AGENT ARRANGEMENTS)

Most open-end investment companies offer various voluntary plans for the purchase, accumulation, or holding of their shares. Even some close-end investment companies offer dividend reinvestment arrangements which somewhat resemble certain plans offered by open-end investment companies. (Procedures similar to those described below should be adaptable to a review of the closed-end arrangements). Some of the plans offered include the following:

a. Share Accumulation Plans

Investors make purchases pursuant to these plans from time to time through a service agent. (See discussion below). Shares are usually held in uncertificated form and dividends are usually automatically reinvested. Some such plans involve a schedule of payments and investors may obtain life insurance relative to their completing the plan.

b. Automatic Dividend Reinvestment Plans

Pursuant to these arangements, investors who hold shares of the investment company can arrange to have all distributions reinvested in shares.

c. Systematic Withdrawal Plans

Pursuant to these plans, an investor who wishes to receive a check for a specific amount of money periodically, usually monthly, makes a large purchase of an investment company's shares and deposits these, or deposits shares previously held, with the investment company or with an agent of the investment company. All distributions on the shares owned are credited to the shareholder's account. At the predetermined dates when checks are due to be transmitted to the shareholder, the distributions accrued plus a liquidation of a portion of the shares in the account equal to whatever is needed to bring the amount of the check up to the specified amount, is made.

d. Pre-Dated Check Arrangements

These arrangements involve an investor giving the investment company or its agent a series of pre-dated signed checks (or similar authorization to periodically draw upon his checking account) in specific amounts. At the designated dates, the investor is credited with the number of shares which can be purchased by the amount of the proceeds of the appropriate check at the current public offering price.

e. Self-Employed Retirement Plans

Under these arrangements investors select or approve a pre-selected custodian. The investors periodically remit payments to the custodian, which then invests the payment in the investment company's shares and is responsible for the accumulation of the shares. The custodial services include maintaining records for the participants and furnishing reports to the Internal Revenue Service.

There are many variations of arrangements in the various plans offered by investment companies. By far however the most important is the common form of share accumulation plan. These plans are becoming an increasingly significant factor in the distribution of investment company shares. It is therefore very important that investment company examiners understand how such plans are operated.

Generally, an investor who wishes to use this method of purchasing shares first fills out an application form and gives it, together with his initial payment, to the retailing broker-dealer. The investor, formally or informally, agrees that a service agent (usually the same institution which is custodian and transfer agent for the company) act as his agent in processing all transactions made pursuant to the plan.

The broker-dealer then signs the application, and directly or indirectly, the same service agent acts as his agent in processing all transactions made pursuant to the plan. He or the investor then forwards the application together with the investor's check to the service agent. The check is made out to the service agent and includes the retailing dealer's commission. The service agent, pursuant to an existing contract with the investment company and/or

the principal underwriter, also acts for them in processing all transactions made pursuant to these arrangements. The service agent receives the initial payment from the broker-dealer, establishes an account for the investor, and apportions the investor's payment among the company, the principal underwriter and the broker-dealer. After crediting the investor's account with the proper number of shares, the service agent sends confirmations of the transaction to the broker-dealer and to the investor. All subsequent payments made by the investor are remitted directly to the service agent. Pursuant to these arrangements, investor transactions are usually with the retailing broker-dealers acting as principal, and not with the investment companies or principal underwriters. The service agent acts simultaneously for all of the parties involved in the transactions.

Some investment company organizations process all transactions in the above manner, both those dealing with certificated shares and with uncertificated shares. Each investor's account statement shows total number of shares owned with a breakdown as to the number of certificated shares and the number of uncertificated shares. Other variations of the above procedures exist where investment companies offer shares directly to the public or where their shares are retailed directly by the principal underwriter.

The examiner should obtain a description of each voluntary plan or other arrangement pursuant to which the investment company's shares can be purchased, accumulated, or held. Where plans or arrangements involve service agents, the following items should be among those reviewed:

A. Fees Paid to Service Agents

The contracts under which service agent functions are being performed should designate as between the company, the principal underwriter, the retailing dealer, the investor, and the party for whom each function is performed. The fee arrangements should be adequately described. The contracts should be reviewed to ascertain that the company is not paying for service agent functions which are being performed for, or are required to be performed by, the principal underwriter or the dealer.

For example, the preparation and mailing of confirmation statements, and the maintenance of commission and other broker-dealer records are not the responsibility of investment companies when the transactions involve principal underwriters and retailing broker-dealers as is generally the case. All such arrangements should be described in the service agent contract.

B. Maintenance of Adequate Facilities by Service Agents and Ability to Meet Financial Responsibility

It is important both to the securities industry customers for whom the service agents are performing and to investors, that service agents possess and maintain the competence and facilities to adequately perform their functions. In addition, service agents should be financially sound and capable of maintaining a high degree of fiscal responsibility. Ordinary business prudence would, of course, require reasonable inquiry into these matters by a mutual fund organization prior to entering into an agreement with a service agent. The examiner should determine whether the service agent appears able to perform its functions in accordance with its agreements and is capable of accepting financial responsibility. Where practicable, the examination should include a visit to the service agent, and its operations should be observed. An inquiry should be made into unanswered correspondence and any backlog of orders, which may be indications of problems. Inquiry should also be made as to whether recent audits of the investment company included a proof of the balances in individual planholder accounts. Significant differences may indicate substantial contingent liabilities.

C. Processing of Sales and Liquidations

The examiner should also review for a representative period, sales and liquidations of voluntary plan shares to determine whether such sales and liquidations were affected in accordance with all applicable requirements, particularly Rule 22c-1 and Section 22(e). Procedures and worksheets similar to those described in Items 17 and 18 of the Manual and the Outline should be used in the review. The review should include an inquiry into the manner in which payments on purchases, proceeds of liquidations, and related notices are transmitted. Review also the manner in which sales load and other charges are deducted and disbursed.

20. CONTRACTUAL PLANS

A contractual periodic payment plan for the accumulation of underlying securities differs from a voluntary plan in that the investor incurs a penalty if he fails to make scheduled payments. Most contractual plans are unit investment trusts in that investor payments are invested in a specified unit or units of underlying securities. Such trusts are required to register as investment companies under the Act whether or not the issuer of the underlying shares is similarly registered. Some contractual plans are management companies and investor payments are pooled into a changing, managed portfolio of securities.

In addition, the contractual plans are considered to be securities and thus, required to be separately registered under the Securities Act regardless of whether or not the underlying securities are similarly registered.

Most contractual periodic payment plans require that 50% of the first year's payments are deducted for sales load. These are commonly known as "front-end load" plans.

Section 27 of the Act and the rules therunder give investors in contractual periodic payment plans certain important rights and protection. 1/ Pursuant to Section 27(d), investors in plans which require that (1) more than 20% of the first year's payments are deducted for sales load; or (2) where the overall sales load exceeds 9%; or (3) where more than 16% of the total of the first four year's payments is deducted for sales load; or (4) where any single deduction for sales load exceeds the amount of sales load for the period subsequent to the first four years' payments: may obtain a cash refund at any time after the first 18 months of their initial purchase of the plan. The refund will consist of the market value of the underlying investment plus the excess of sales load which is more than 15% of the gross amount of the payments.

Section 27(f) requires that all periodic plan investors have the right to obtain a refund equal to the market value of the underlying investment plus all deductions from payments over the net amount invested, within 45 days of the date of the receipt of a notice to that effect. The notice is required to be mailed within 60 days of the purchase of the plan.

1/ See Appendix I-M, Investment Company Act Release No. 6392, Provisions of the Investment Company Amendments Act of 1970 Relating to Periodic Payment Plans.

Rule 27d-1 requires that a segregated trust account be maintained by principal underwriters and depositors to enable the refund of monies as described above. 1/ However, in lieu of maintaining a segregated trust account, Rule 27d-2 allows an insurance company to provide a written guarantee as to the performance of its obligations under Sections 27(d) and 27(f) of the Act. Rules 27e-1 and 27f-1 contain requirements as to notices which should be sent to certain delinquent planholders. 2,3,4/ A financial report on Form N-27D-1 is required to be filed with the Commission on a quarterly basis.

A "typical" contractual plan arrangement usually involves a unit investment trust. The underlying shares are usually shares of an open-end investment company within the same organizational complex. The sponsor of the trust usually acts as the principal underwriter for the plans. The sponsor is generally a subsidiary of the investment adviser of the underlying open-end investment company, or is under common control with the adviser. The following is a brief description of three types of contractual plans offered by a "typical" unit trust.

A. Single Payment Plans

Single Payment Plans require an investor to make a lump sum payment of a specified minimum denomination (usually not less than $5,000) with large denomination plans being available in multiples of $50 or $100.

B. Periodic Payment Plans (Without Insurance):

Periodic Payments Plans (Without Insurance) are offered in denominations involving monthly payments ranging from $10 to $1,000 or more, usually in multiples of $5 or more. Such plans require a series of payments over a specified period of years, normally not less than ten years, and occasionally contain an option on the part of the Planholder to extend the payment period for an additional specified period of years.

1/ See Appendix I-N-1, Investment Company Act Release No. 6600 Adoption of Rules 27d-1, 27d-2, 27e-1, 27f-1, 27g-1 and 27h-1.

2/ See Appendix I-N-2, Investment Company Act Release No. 6653, Amendment to Instructions to Forms N-27E-1 and N-27F-1.

3/ See Appendix I-N-3, Investment Company Act Release No. 6048, Adoption to Amendments to Rule 27f-1.

4/ See Appendix I-N-4, Investment Company Act Release No. 7152, Amendment to Forms N-27E-1 and N-27F-1.

C. Periodic Payment Plans (With Insurance)

Some plans feature a life insurance tie-in. The insurance provides for the completion of the plan in the event of the death of the investor. Periodic Payment Plans (With Insurance) are offered in denominations involving monthly payments ranging from $10 to $300 in multiples of $5 or more. Such plans require a series of payments over a specified period of years, normally not less than ten years and occasionally contain an option on the part of the Planholder to extend the payment period for an additional specified period of years. In this latter instance, insurance coverage is not available on the extended period. Such Plans also provide for the deduction of a premium for group creditor life insurance coverage obligating the insurors to complete the Plan in the event of the death of the Planholder prior to his completion of the payments required under the Plan.

General Provisions

Each of the above Plans, when issued, is registered in the name of the Planholder and is in the form of an individual agreement between the sponsor company of the Plan, the custodian bank under the Plan, and the Planholder. The custodian bank msut meet all of the standards and provisions contained in Section 26 of the Act.

Normally, each Plan, unless terminated by the Planholder, shall continue in force for a specified period of years, and no amendments which would affect outstanding Plans adversely may be made at any time during the period of the Plan without the Planholder's expressed consent.

Under all Plans certain optional provisions are usually extended to Planholders. These include the following:

Income Dividends and Capital Gain Distributions. Planholders may direct that the amount of any income dividends and any capital gain distributions, after applicable deductions as specified in the Plan, be applied to the purchase of additional shares at net asset value or to remit the net amount of such dividends and distributions to him in cash. The authorization in either respect may be revoked at any time at the Planholder's option; however, in the absence of any authorization, usually the Plan provides that any such dividends and distributions will be reinvested at net asset value automatically.

A Declaration of Trust. Frequently, a Planholder may, without transferring his Plan, execute and file with the custodian from time to time revocable declarations of trust declaring that he holds his Plan and the shares held thereunder in trust for the benefit of a designated person upon the terms therein stated.

Partial Withdrawal or Partial Liquidation Without Termination. Plans normally provide that at any time after a specified period from the date of purchase the Planholder may, without termination of the Plan, withdraw part of his accumulated shares or receive in cash the value of such shares at the time of the partial withdrawal, provided that the cash liquidation involves not less than a specified dollar amount and the withdrawal or liquidation of shares shall equal not more than a specified percentage (80% or 90%) of his accumulated total. Such withdrawals are normally permitted to be made only once a year in order to comply with an interpretation announced by the National Association of Securities Dealers on July 22, 1966, effective August 1, 1966.

Transfer or Assignment. Plans normally provide that the Planholder may assign his Plan and the shares held thereunder to a bank or loan institution as security for a loan; or he may transfer and assign his Plan and shares to another person acceptable to the sponsor and custodian.

Complete Withdrawal and Termination. Holders of Single Payment Plans and Periodic Payment Plans Without Insurance may, at any time, terminate their Plans by surrendering same to the custodian and requesting delivery of the shares accumulated thereunder, or having the value of the shares remitted in cash. Periodic Payment Plans With Insurance in force may only be terminated during the lifetime of the Planholders.

Reinstatement of Lapse Insurance. The holder of a Plan with insurance is generally deemed to be in default whenever he fails to make any payment on or before the date when due. In those cases where a Planholder under such a Plan, which has been in default for a period of more than 31 days, the terms and conditions of the insurance policies usually provide that insurance upon the Planholder's life will automatically lapse. During the period starting within the 32nd day after the date of default, the Planholder may resume payments, but normally only under certain conditions as specified in the Plan. Some Plans also provide that if the Planholder is in default, underlying shares will be liquidated over a specified period of months to pay the insurance premiums and thereby assure the Planholder of

insurance coverage until the Planholder resumes making regular monthly payments. In all instances of default, the duration of the Plan is usually extended for the period of time in default.

Reports, Receipts and Notices. Normally, the custodian mails to each Periodic Payment Planholder a receipt for each payment, including a statement of the number of shares held for his account, and notices of payments due in advance of their due date. All Planholders also receive copies of the updated underlying fund's prospectus, proxy statement, and annual and semi-annual reports. In addition, all Planholders receive distribution notices and tax statements relating to the Plan. Various notices in connection with refund privileges, as described earlier, are also required to be forwarded to Planholders.

Voting Rights. In the dissemination of the underlying fund's proxy soliciting material, the custodian requests that the Planholder execute and return to the custodian instructions for voting the underlying shares on the matters set forth in the proxy statement. In the absence of any instructions from Planholders, the custodian normally votes the shares for or against each matter on which the Planholder is entitled to vote in the same proportion as indicated in the voting instructions given to the custodian by other Planholders.

Prepayment. Some plans provide that the Planholders may accelerate completion of their Periodic Payment Plans by making payments in multiples of their regular payments in advance of their due dates. Such prepayments do not, however, accelerate the due dates of unpaid payments. Certain disclosure provisions are required in the Plan prospectuses where Plans provide for prepayment, and in some instanes there is a reduction in the custodian fees resulting from such prepayments.

At the outset of examinations involving contractual plan organizations, a detailed inquiry should be made into each type of plan offered or outstanding. If a unit investment trust is involved, the underlying security or securities should be noted. All of the entities involved in the administration, management, or distribution of the plans should be identified and their roles ascertained.

At this point in the examination, the information noted above should be reviewed and the examiner should determine what steps described in other sections of the Manual and Outline would be appropriate to follow under the circumstances involved. For example, if the company is not a unit trust and the assets consist of a general portfolio of investments, reviews of the net asset value calculation, the investment decision making process,

trading practices, and possible other areas are in order. If the company is a unit trust and the underlying shares are operating companies, a limited review of trading practices may be warranted. In any event, a trial balance should be taken or otherwise obtained and reviewed, and the number of outstanding units and underlying assets should be verified.

The instruments under which the plans are established should be examined and the prospectus and sales literature disclosures used in promoting sales of the plans should be reviewed. A determination should be made as to whether the described functions are being performed properly and in accordance with disclosures, particularly the following:

a. Pricing of shares in relation to time of receipt of orders for both sales and liquidations.

   1. Worksheets similar to those decribed in Items 17 and 18 may be used for this purpose if appropriate.

b. Transmittal of payments on purchases and proceeds on liquidations between all entities involved.

c. Confirmations to planholders and notices to involved entities.

d. Deductions for sales loads and other charges.

A careful review should be made of sales practices, particularly where a captive retail sales force is involved. In connection with this review, obtain details from the plan organization as to the "completion experience" of planholders. Most plan organizations maintain records detailing such experience. Where captive sales forces are not involved, an attempt should be made to identify dealers and individual sales representatives who may appear to be overselling as indicated by chronically negative experience results.

The examination should also include a review of the refund arrangements including the reserve requirements. Inquiry should be made as to the procedures in effect. The manner in which refunds are handled should be checked for compliance with applicable requirements. The segregated trust account arrangements should be checked against the requirements of Rule 27d-1. If an insurance company undertaking is in effect in lieu of segregated reserves, check for compliance with Rule 27d-2. Review the latest submitted Form 27d-1 for propriety. Check

also that 27F-1 and 27E-1 notices are being properly transmitted to planholders. Test-check recent refunds to planholders for proper computation and for compliance with the Sections 27(d) and 27(f).

PART III. COMPLETING THE EXAMINATION AND PREPARING THE REPORT

1. COMPLETING THE EXAMINATION

When the examiner in charge feels that everything that must be done within the Company's offices has been completed, arrangements should be made to have a final discussion with the principal executive officer or his representative. The purpose of the final discussion should be to clarify and expand on any items which are in doubt. At this time, problem areas may be discussed to the extent authorized by Regional Office policy, but only for the purpose of obtaining additional information. It also helps to set up the possibilities of further discussion (by either phone or visit) in the event that questions develop during later phases of the examination or during the preparation of the report.

2. PREPARING THE EXAMINATION REPORT

After all of the items in the Examination Outline are completed, all requested information is received and analyzed, and problem areas have been thoroughly explored, the examination report should be prepared by the examiner in charge. The report consists of facing pages, a checklist, and recommendations at to further action.

The checklist is designed so that it follows the format of and can be prepared directly from the Outline. The Outline should contain pencil written comments on each item listed. The comments should indicate whether or not the item was reviewed during the examination, the extent of the review, reference to workpapers or other exhibits, description of deficiencies noted, and any other comments.

Other than those items in which deficiencies are noted, narrative comments need only be made where, in the opinion of the examiner, it is a matter of significant importance and interest. In most cases,

the narrative comments can be reduced by attaching copies of an investment company's latest prospectus, annual or semi-annual report to shareholders, and proxy statement to the report. It cannot be emphasized too strongly, however, that the use of a checklist form of report places a great deal of responsibility on the examiner who prepares and submits the report. The examiner should be able to substantiate, mainly through the Outline, each answer indicated on the checklist.

3. REGIONAL OFFICE REVIEW OF EXAMINATION REPORTS

The use of the checklist form of report makes it essential that a thorough and reliable review of the report by supervisory personnel be conducted at the Regional Office level where supporting documents and workpapers are available. At a minimum, reviewing personnel should check each item in the report against the Examination Outline to ascertain that the examiner's responses as indicated in the report are accurate and reflective of the information obtained during the examination.

4. RECOMMENDATIONS AS TO FURTHER ACTION

The Regional Administrator has the primary responsibility for recommending and implementing further action as to violations disclosed as a result of examinations. The various divisions of the Headquarters Office will make every effort to assist the Regions in making such determinations if requested, and will also assist in implementing corrective actions to the extent such assistance is necessary.

If a deficiency letter is mailed to the investment company, a copy of the letter should be attached to the report. Similarly, copies of memoranda, referral letters, and other documentation supporting the recommendations or implementation of such recommendations should be attached to the report.

5. TRANSMITTING THE REPORT

Three copies of the examination report for each investment company included in the report should be transmitted to the Division of Investment Management. Reports need not be delayed pending the resolution of problems noted during examinations. Instead, the reports should be promptly submitted and pending problems described to the extent possible, together with a description of how the problems are being handled. Memoranda of follow-up action can be forwarded later.

Where follow-up action is being taken in the form of a deficiency letter, the investment company should be notified to submit a copy of any communication regarding these matters to:

U. S. Securities and Exchange Commission
Division of Investment Management
Branch of Compliance
500 North Capitol Street
Washington, D,C, 20549

When an investment company examination report cannot be prepared within thirty days after the completion of the examination, or when the report cannot be submitted to be Division within sixty days after the completion of an examination, serious consideration should be given to conducting a further visit to the subject investment company prior to the preparation or submission of the report for the purpose of ascertaining the accuracy and currency of the matters related therein.

One reason for the checklist type of report is to facilitate the preparation of examination reports so that information gathered during examination can be put into use by the staff of the Regional Office and the Division while still current. The reports are used extensively in making day to day decisions in connection with clearing various filings, processing applications, and other matters. If is important that the reports be received while they still reflect existing conditions. Also, it has been observed that delayed preparation of reports can contribute to incomplete or inaccurate findings and conclusions.

In completing an inspection report, all reports, unless otherwise notified, should include a copy of a completed Report of Investment Company Examination (SEC Form 1105), Investment Company Inspection Outline (SEC Form 1010), a supplementary comment section where appropriate, all pertinent documentation used to support the findings noted in the inspection report, and a copy of all correspondence relating to the examination and follow-up therewith. Please use discretion in submitting back-up documentation to minimize the size of the inspection report. Where findings relate to a specific page or pages of a prospectus, proxy or other report on file with the Commission, the inspection report need only include a copy of those relevant page(s).