Blogs
May 04, 2017
Section 848 of the Financial Choice Act 2017: Unwise at any Speed (Part 1)

Most observers of the Investment Company Act of 1940 ("1940 Act") would agree that, (i) without the exemptive authority in Section 6(c), Section 17(b), and in other provisions in the 1940 Act and (ii) without the manner in which the SEC and its staff have used that authority, the 1940 Act would have become obsolete insofar as it would not have been possible to adapt it to some of the most popular financial products developed during the last 40 years. It is also true that the process for obtaining exemptive orders is far from perfect and has proven to be frustrating on more than one occasion. Presumably, these frustrations motivated a proposed "reform" to the exemptive application process as part of the pending Financial Choice Act 2017. Specifically, Section 848 would attempt to accelerate the process of obtaining exemptions by forcing the SEC to grant or deny an exemptive application within a fixed time frame. This proposal: (a) does not reflect a sophisticated understanding of the process it seeks to change and, therefore, (b) fails to identify the actual problems with the process, so that Section 848 would almost certainly (c) result in superficial changes at best and at worst seriously undermine the protections the 1940 Act provides to shareholders of investment companies. This series of posts will consider each of these points, before recommending more appropriate changes to the processes of obtaining exemptions.

The Significance of the SEC's Exemptive Authority

Section 6(c) of the 1940 Act gives the SEC the authority to:

> conditionally or unconditionally exempt any person, security, or transaction, or any class or classes of persons, securities, or transactions, from any provisions of this title or of any rule or regulation thereunder, if and to the extent that such exemption is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of [the 1940 Act].

The SEC staff must affirmatively find, essentially, that the object of the proposed exemption is in the best interests of shareholders. Described in law-and-economics terminology, Congress set the transactions costs of seeking an exemptive order under Section 6(c) so high that only certain proposed transactions can bear the costs in time and money of seeking an exemptive order. A similar analysis could be made of Sections 17(a) and 17(b) of the 1940 Act, and Sections 23A and 23B of the Federal Reserve Act, each of which also serve to protect an entity (the investment company or the bank) from being overreached by its affiliated persons. Notably, the SEC has used this authority to permit the introduction of:

- commingled managed agency accounts,
- variable annuity contracts and variable life insurance,
- money market funds,
- multiple share classes, and
- ETFs, separately managed advisory accounts, and funds of funds

Most of these exemptions have been codified eventually by the SEC into exemptive rules of general applicability. Thus, the issuance of exemptive orders plays a critical role in the administration of the 1940 Act and in the development the SEC's evolving regulatory policies—a consequence that the proposed reform would completely, but thoughtlessly, eviscerate.

The Current Exemptive Process

To issue an exemptive order, the SEC must find that, among other things, the exemption being sought is in the

public interest and for the protection of investors. The applicant for exemption has the burden of providing the facts and proffering a persuasive legal analysis to support these findings. At present, if the SEC staff cannot support the exemptive order being sought, the only procedural alternative available is for the SEC to set the matter down for a hearing before an SEC administrative law judge. That procedural choice does provide an opportunity for an aggrieved applicant to advocate for the order that it is seeking, and thus provides some degree of procedural due process. However, that procedural alternative is not available until the SEC staff has decided whether or not to support the exemptive order being sought. The SEC staff has not infrequently taken a considerable period of time to come to a conclusion with respect to any particular exemptive application. Even if the SEC staff is prepared to support issuing an order, it is still commonplace for conditions to be appended to that order designed to provide certain investor protections in lieu of the statutory protections from which the applicant is seeking an exemption. Consequently, substantially all of the timing and substance of an exemptive order is usually within the sole discretion of the SEC staff.

Explore more in

Investment Management