



UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549

DIVISION OF  
INVESTMENT MANAGEMENT

ACT TCA  
SECTION 3(a)(3), 17(a), 17(d)  
RULES 2a-7, 17d-1  
PUBLIC AVAILABILITY **PUBLIC**

May 14, 1998

Craig S. Tyle, Esq.  
General Counsel  
Investment Company Institute  
1401 H Street, N.W.  
Washington, D.C. 20005-2148

Re: Deferred Compensation Plans for Investment Company Directors

Dear Mr. Tyle:

The staff of the Division of Investment Management has over time received a number of inquiries from members of the investment management industry and their counsel concerning the status under the Investment Company Act of 1940 (the "Act") of deferred compensation plans for investment company directors. We believe that a clarification of this issue may be useful to the Investment Company Institute and to its members and have prepared this letter for that purpose.

BACKGROUND

Many registered investment companies ("Funds") have implemented compensation plans to allow their directors to defer receipt of the fees they receive in that capacity to obtain tax and other benefits. Under the plans, a deferred account is created and then credited or charged during the deferral period with income, gains and losses based on the performance of a specified security or securities ("Underlying Securities"). A Fund generally covers its obligation to fund the deferred account by purchasing the Underlying Securities or by creating an account on its books that tracks the performance of the Underlying Securities ("Phantom Account").

In a number of letters issued since 1982, the staff has stated that it would not recommend that the Commission take enforcement action if a Fund implemented a deferred compensation plan without obtaining an order from the Commission.<sup>1</sup> Funds generally have requested no-action assurances regarding whether the plans created senior securities for

<sup>1</sup> See, e.g., The North Carolina Cash Management Trust (pub. avail. Jan. 23, 1992).

purposes of Sections 18(f) and 13(a)(2) of the Act, whether the plans involved the issuance of Fund securities for services under Section 22(g) of the Act, and whether the plans were inconsistent with restrictions on the transferability or negotiability of Fund securities under Section 22(f) of the Act. Funds also have requested assurances regarding whether, when the Underlying Securities were not issued by an affiliated person of a Fund, the plan was a "joint enterprise, joint arrangement, or profit-sharing plan" under Section 17(d) of the Act and Rule 17d-1 under the Act.

Since 1982, the Commission has granted over 60 orders, generally providing exemptions from the provisions cited above, to permit deferred compensation plans. It appears that applicants have continued to request orders for deferred compensation plans, as opposed to relying on the no-action letters, for four reasons. The first reason is that applicants believe that Section 17(d) and Rule 17d-1 may apply to a plan when the return of the deferred account is based on the investment performance of a Fund on whose board the director serves or a Fund that is an affiliated person of such a Fund (collectively, "Affiliated Funds"). The plans described in applications generally provide that the return of the deferred account is based on the performance of the Affiliated Fund or Funds selected by the director.<sup>2</sup> In the letters, the return of the deferred account typically is based on some other benchmark.<sup>3</sup>

The second reason that applicants have continued to request orders is that a money market Fund's participation in a deferred compensation plan can raise issues of compliance with Rule 2a-7 under the Act. Deferred compensation plans create special concerns for a money market Fund that holds the Underlying Securities because the amount of a Fund's obligation to fund the deferred account is measured by the performance of the Securities, which may not be eligible investments under Rule 2a-7. Thus, when money market Funds have participated in deferred compensation plans, they have obtained

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<sup>2</sup> In certain applications, the return of the deferred accounts was based on the return of an affiliated fixed-income account. *See, e.g.*, EQ Advisors Trust and EQ Financial Consultants, Inc., Investment Company Act Release Nos. 22883 (Nov. 12, 1997) (notice) and 22931 (Dec. 9, 1997) (order); The Equitable Trust, Investment Company Act Release Nos. 17025 (June 22, 1989) (notice) and 17072 (July 19, 1989) (order); and Harmony Investment Trust, Investment Company Act Release Nos. 15913 (Aug. 11, 1987) (notice) and 15970 (Sept. 10, 1987) (order).

<sup>3</sup> *See, e.g.*, The North Carolina Cash Management Trust, *supra* n. 1 (return of deferred account based on prevailing rate on 90-day U.S. Treasury Bills).

exemptions to permit them to operate in reliance on Rule 2a-7 while also investing in Underlying Securities.<sup>4</sup>

The third reason that applicants have requested orders is that the Funds may wish to cover their obligations to fund the deferred accounts by purchasing Underlying Securities issued by Affiliated Funds. Funds have obtained exemptions from Section 17(a) of the Act to the extent necessary to permit them to purchase and redeem Underlying Securities issued by Affiliated Funds.

The final reason for the requests for orders is that many Funds have investment policies that prohibit the purchase of shares of other investment companies without shareholder approval. These Funds have obtained exemptions from Section 13(a)(3) of the Act to the extent necessary to permit them to purchase Underlying Securities issued by other Funds.

### ANALYSIS

#### Section 17(d) and Rule 17d-1

Section 17(d) of the Act and Rule 17d-1 under the Act, in relevant part, make it unlawful for any affiliated person of a Fund, or any affiliated person of an affiliated person, acting as principal, to participate in or effect any transaction in connection with a "joint enterprise or other joint arrangement or profit-sharing plan" in which the Fund participates unless the transaction has been approved by the Commission.<sup>5</sup> Rule 17d-1(c) defines the phrase "joint enterprise or other joint arrangement or profit-sharing plan" to include any arrangement in which the affiliated person and the Fund

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<sup>4</sup> Rule 2a-7 provides that it is not a violation of Sections 34(b) or 35(d) of the Act for a Fund to hold itself out to investors as a money market fund or to use the term "money market" in its name if it satisfies the requirements in the rule with respect to the maturity, quality and diversification of its portfolio. If a money market Fund meets these and certain other requirements in Rule 2a-7, the Fund also may compute its current price per share using the amortized cost method or the penny rounding method, notwithstanding the requirements of Section 2(a)(41) of the Act and Rules 2a-4 and 22c-1 under the Act.

<sup>5</sup> Under the definition of "affiliated person" in Section 2(a)(3) of the Act, a director of a Fund is an affiliated person of the Fund and, because Affiliated Funds may be deemed to be affiliated persons, for example, by reason of having a common investment adviser, the directors may be deemed to be affiliated persons of affiliated persons of each Affiliated Fund.

“share in the profits of the enterprise or undertaking,” including any “stock option or stock purchase plan.” Because basing the return of a deferred account on the performance of an Affiliated Fund may appear to be a form of profit sharing, applicants have sought orders under Section 17(d) and Rule 17d-1.

The staff believes that basing the return of a deferred account on the performance of an Affiliated Fund does not create a “profit-sharing plan” under Section 17(d) and Rule 17d-1.<sup>6</sup> The staff previously has taken the position that a plan possesses profit-sharing characteristics if it requires payments to be made on the basis of the performance of an Affiliated Fund *and* if the Fund that is participating in the plan is obligated to make the payments as compensation.<sup>7</sup> Payments made pursuant to a typical deferred compensation plan, however, are not compensation for purposes of this position because the payments are not made in return for the provision of services. Rather, the payments arise from the director's investment, in effect, of his or her own assets in the Affiliated Fund. The director's economic return from the Affiliated Fund is essentially the same as that of a holder of the Affiliated Fund's shares. We therefore believe that using an Affiliated Fund as the benchmark for the deferred account would not implicate Section 17(d) or Rule 17d-1.<sup>8</sup>

#### Rule 2a-7

Paragraph (c)(3)(i) of Rule 2a-7 under the Act requires that money market Funds invest only in “eligible securities,” which generally are limited to high quality, short-term debt securities under paragraph (a)(9) of the rule. The amount of a Fund's obligation to fund a deferred account depends upon the value of the Underlying Securities. The

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<sup>6</sup> We also believe that using an Affiliated Fund as a benchmark for a deferred account does not create a joint enterprise or arrangement. A joint arrangement under Rule 17d-1 requires “some element of combination” between the Fund and its affiliate. SEC v. Talley Industries, Inc., 399 F.2d 396, 403 (2d Cir. 1968), *cert. denied*, 393 U.S. 1015 (1969). We believe that the mere fact that the return of a deferred account is based on the performance of an Affiliated Fund does not establish the requisite degree of combination.

<sup>7</sup> First Midwest Corp. (pub. avail. Jan. 5, 1981).

<sup>8</sup> To the extent that this position may be inconsistent with prior staff positions, those positions are superseded. *See, e.g.*, CNA Income Shares, Inc. (pub. avail. Jan. 18, 1982) (paying deferred compensation based on the investment performance of an Affiliated Fund would constitute a “joint enterprise, joint arrangement, or profit-sharing plan” under Section 17(d) and Rule 17d-1); First Midwest Corp., *supra* n. 7 (same).

Underlying Securities, however, might not be eligible securities, and they therefore may pose a greater risk of loss than the types of securities in which a money market Fund is permitted to invest.

To address this concern, the orders granted by the Commission to money market Funds to permit them to operate in reliance upon Rule 2a-7 and invest in Underlying Securities have been based, in part, on the condition that the Funds buy and hold the Underlying Securities.<sup>9</sup> This requirement ensures an exact match between the money market Fund's deferred account liability and the value of the deferred account.<sup>10</sup> Thus, the money market Fund and its shareholders are insulated from the risks posed by the Underlying Securities.

The staff believes that a money market Fund may participate in deferred compensation plans of the type described in prior applications for orders consistent with the purposes of Rule 2a-7. We note particularly the condition of the orders that each money market Fund will buy and hold the Underlying Securities to create an exact match between the value of the deferred account and the Fund's deferred account liability. Under these circumstances, the staff would not recommend that the Commission take any enforcement action if a money market Fund operates in reliance upon Rule 2a-7, notwithstanding the fact that it invests in Underlying Securities pursuant to a deferred compensation plan.

Section 17(a)

Section 17(a) of the Act generally prohibits any affiliated person of a Fund and any affiliated person of such a person from selling any security to, or purchasing any security from, the Fund. As described above, Funds may cover their obligations to fund the deferred accounts by purchasing Underlying Securities or by creating Phantom Accounts. Funds have obtained exemptions from Section 17(a) to permit them to purchase and redeem shares of other Affiliated Funds.

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<sup>9</sup> See, e.g., Ssga Funds and State Street Bank and Trust Co., Investment Company Act Release Nos. 22999 (Jan. 14, 1998) (notice) and 23026 (Feb. 10, 1998) (order).

<sup>10</sup> Orders granted to money market Funds, unlike those granted to other Funds, have not permitted the money market Funds to cover their deferred compensation liability by establishing Phantom Accounts. Because a Phantom Account would subject a money market Fund to the risks posed by the Underlying Securities, we believe that using a Phantom Account may be inconsistent with the purposes of Rule 2a-7. For this reason, the staff's position in this letter does not apply to a money market Fund's use of a Phantom Account.

Applicants requesting exemptions from Section 17(a) generally have represented that purchases of Underlying Securities would not be made for investment purposes, but solely to cover each Fund's obligation to fund a deferred account. Applicants also have stated that the amount involved would be *de minimis* in relation to the total assets of each Fund that is participating in the deferred compensation plan. Under these circumstances, the staff would not recommend that the Commission take any enforcement action under Section 17(a) if a Fund purchased and redeemed shares of an Affiliated Fund pursuant to a deferred compensation plan.

Section 13(a)(3)

Section 13(a)(3) of the Act provides that a Fund may not, unless authorized by a vote of a majority of its shareholders, deviate from any investment policy that is changeable only by shareholder vote or any policy that is "fundamental" under Section 8(b)(3) of the Act. Many Funds have investment policies that prohibit the purchase of shares of other investment companies and that are subject to the shareholder voting requirement of Section 13(a)(3) ("Restricted Funds"). These Funds therefore have obtained exemptions from Section 13(a)(3) to permit them to purchase Underlying Securities issued by investment companies without obtaining shareholder approval.

Applicants requesting such exemptions typically have represented that the amount of the Fund's obligation to fund the deferred account would be *de minimis* in relation to the total assets of the Fund and that the value of the Underlying Securities would equal the amount of the liability. Thus, purchases of the Underlying Securities would have no material effect on a Fund's risk characteristics or investment return. We therefore believe that the purchase of the Underlying Securities would not be inconsistent with shareholders' expectations. Under these circumstances, the staff would not recommend that the Commission take any enforcement action under Section 13(a)(3) if a Restricted Fund purchased Underlying Securities issued by investment companies.

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We hope that this letter clarifies the staff's current positions regarding deferred compensation plans, and we would appreciate your informing your members of our views.<sup>11</sup> Those Funds that have received orders to implement plans may rely on this letter or may continue to rely on those orders. In our view, Funds that wish to implement deferred compensation plans as described in this letter need not seek orders from the Commission covering the plans. If you have any questions about this letter or the issues raised above, please contact me at (202) 942-0564.

Sincerely,



Nadya B. Roytblat  
Assistant Director

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<sup>11</sup> We note that the positions in this letter are based on deferred compensation plans in which the deferred accounts are liabilities of the Funds and those liabilities are covered by Fund assets. We note our view that a deferred compensation plan that is structured so that the deferred account is not a liability of the Fund and is not covered by Fund assets would not appear to raise any of the issues under the Act and its rules discussed above.