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Oversight of and Compliance With Conditions and Representations Related to Exemptive Orders and No-Action Letters

June 29, 2011
Report No. 482

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

OFFICE OF
INSPECTOR GENERAL

MEMORANDUM

June 29, 2011

To: Eileen Rominger, Director, Division of Investment Management
Robert W. Cook, Director, Division of Trading and Markets
Meredith Cross, Director, Division of Corporation Finance
Carlo V. di Florio, Director, Office of Compliance Inspections and Examinations

From: H. David Kotz, Inspector General, Office of Inspector General (OIG)

Subject: *Oversight of and Compliance with Conditions and Representations Related to Exemptive Orders and No-Action Letters,* Report No. 482

This memorandum transmits the U.S. Securities and Exchange Commission OIG's final report detailing the results of our review of the SEC's oversight of and compliance with the conditions and representations related to exemptive orders and no-action letters. This review was conducted as part of our continuous effort to assess management of the Commission's programs and operations and as a part of our annual audit plan.

The final report contains five recommendations which if fully implemented should enhance the Commission's oversight of compliance with conditions and representations in exemptive orders and no-action letters. The respective offices concurred with all five of the report's recommendations. Your written response to the draft report is included in Appendix V.

Within the next 45 days, please provide the OIG with a written corrective action plan that is designed to address the report's recommendations. The corrective action plan should include information such as the responsible official/point of contact, timeframes for completing required actions, and milestones identifying how you will address the recommendations.

Should you have any questions regarding this report, please do not hesitate to contact me or Jacqueline Wilson at ext. 16326. We appreciate the courtesy and cooperation that you and your staff extended to our auditor.

Attachment

cc: James R. Burns, Deputy Chief of Staff, Office of the Chairman
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Oversight of and Compliance With Conditions and Representations Related to Exemptive Orders and No-Action Letters

Executive Summary

Background. The Securities and Exchange Commission (SEC or Commission) has statutory authority to issue exemptive orders, in response to an entity's request, that allow the entity to engage in transactions that would otherwise be prohibited by the securities laws, rules, or regulations. In some instances, instead of exemptive relief, a company may request a "no-action" letter from Commission staff. A no-action letter states that the staff will not recommend enforcement action in response to the entity's proposed activity. Exemptive orders and no-action letters allow the Commission to provide flexibility and accommodate situations not originally contemplated by the securities laws.

The Commission's statutory general authority to provide exemptive relief is located in Section 28 of the Securities Act of 1933, Sections 12(h) and 36 of the Securities Exchange Act of 1934, Section 6(c) of the Investment Company Act, and Section 206A of the Investment Advisers Act of 1940. The Commission has delegated authority to its program Divisions to issue exemptive orders. The Division of Investment Management provides exemptive relief under the Investment Company Act of 1940 and the Investment Advisers Act of 1940. The Division of Trading and Markets provides exemptive relief pursuant to the Securities Exchange Act of 1934 to entities, including regulated entities such as broker-dealers and exchanges, and for certain market activities. The Division of Corporation Finance provides exemptive relief under the securities registration and reporting sections of the Securities Exchange Act of 1934. These divisions may coordinate on exemptive relief regarding cross-cutting securities laws issues—for example, auction rate securities.

Exemptive relief was not intended to provide unrestricted or unlimited relief from the securities laws and rules, however. For example, the Commission has noted the following regarding the general exemptive authority under the Investment Company Act of 1940: "[T]he exceptional power under Section 6(c) to free any person from any or all provisions of the [Investment Company] Act is one which must be exercised with circumspection and with full regard to the public interest and the purposes of the [Investment Company] Act . . . ."[1] In order to provide exemptive relief under Section 36 of the Exchange Act, "the Commission must determine that the exemption is necessary or appropriate in the public interest and is consistent with the protection of investors."[2] While the Commission may provide unconditional exemptive relief, it generally requires that the recipient of the relief comply with specified conditions. If the SEC grants an

[1] *In re The Great American Life Underwriters, Inc.*, File No. 811-423 (July 15, 1960) at 5 (footnote omitted).
[2] "Exchange Act Exemptive Applications," www.sec.gov/rules/exempt.shtml.

exemption that contains conditions, the requestor must adhere to the conditions of the exemptive relief issued by the Commission or a Division acting pursuant to delegated authority in order for the exemption to have any effect.

In some instances, instead of exemptive relief from the provisions of the securities laws, a company will request assurances, known as "no-action" letters, from Commission staff that the staff will not recommend enforcement action in response to the company's proposed activity. No-action letters expressly represent only a position by the staff based on the facts and circumstances described in the request, and the letters expressly do not represent legal conclusions or opinions. No-action letters are intended to assist industry in complying with the securities laws by providing the Divisions' staff positions on contemplated transactions. The Division staff clearly state in the no-action letters that the relief granted is based solely on the facts and representations presented, and that any different facts or conditions might require another conclusion.

Compliance by registered entities with the conditions and representations in exemptive orders and no-action letters is reviewed primarily by the Office of Compliance Inspections and Examinations (OCIE) as part of its inspections and examinations program. OCIE conducts examinations of firms that are registered with the Commission, including registered broker-dealers, transfer agents, clearing agencies, investment advisers, and investment companies (collectively "regulated entities"). According to OCIE, it has been a longstanding practice for examiners to review, as part of pre-examination work, exemptive orders and no-action letters that have been issued to the registrant being examined. OCIE indicated that an examination report or deficiency letter will include the results of OCIE's review of compliance with exemptive orders or no-action letters if potential violations of the law are found. The Division of Trading and Markets' Office of Market Operations has on occasion reviewed compliance with information technology-related conditions of certain temporary exemptive orders, but does not engage in any systematic monitoring of such orders.

Objectives. The objective of the review was to assess the Commission's processes for ensuring adherence to the conditions under which exemptive orders and no-action letters are granted to regulated entities.

Prior OIG Report. The Office of Inspector General audited the exemptive application process in the Division of Investment Management's Office of Investment Company Regulation (Report No. 408, September 29, 2006), to determine whether the process was timely and to recommend improvements. The report included 13 recommendations. Recommendations to enhance timeliness included issuing exemptive rules, filing applications electronically, and restricting or eliminating the review of draft exemptive applications. Other recommendations included returning poorly prepared applications, developing standard follow-up procedures, improving performance measures, and revising the database for exemptive applications. The Division of Investment Management concurred with and addressed all 13 recommendations, and the recommendations were closed.

Results. The review found that the Commission can improve its processes for monitoring compliance with conditions and representations related to exemptive orders and no-action letters in a variety of ways. Significantly, the review found that the SEC's Divisions that issue exemptive orders and no-action letters to regulated entities do not have a coordinated process for reviewing these entities' compliance with the conditions and representations contained in the orders and letters, and instead rely on OCIE to review compliance as part of its examinations. Because exemptive orders and no-action letters allow industry participants to conduct activities that, without the relief, could violate the securities laws and regulations, the review determined that monitoring is important to ensure the compliance with the conditions and representations in exemptive orders and no-actions letters issued to regulated entities. To achieve effective monitoring, the Divisions should engage in increased coordination with OCIE's examinations of regulated entities as they pertain to compliance with the conditions and representations in exemptive orders and no-action letters.

The review further determined that the Divisions separately track data regarding processed exemptive orders and no-action letters in various ad hoc spreadsheets and databases and that the collected data does not include information on compliance with the conditions and representations in exemptive orders and no-action letters. In addition, while OCIE's examination tracking system tracks violations of the federal securities law identified through inspections and examinations, OCIE's system does not identify the exemptive order or no-action letter that may be related to the violation. The review also found that while the Divisions and OCIE occasionally share information pertinent to exemptive orders and no-action letters, the process is informal and not systematic. Because the Divisions do not systematically capture and analyze data on compliance with the conditions and representations in exemptive orders and no-action letters issued to regulated entities, we determined that the Commission is less effective than it could be in monitoring compliance with such conditions and representations.

Similarly, the review found that the SEC's current organizational structure separates the agency's rulemaking and examinations functions and that there is no formalized coordination between these functions. As noted above, there is also no formalized process for monitoring or ensuring compliance with the conditions and representations in exemptive orders and no-action letters. We noted that the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 requires the Divisions of Investment Management and Trading and Markets to include examiners on their staffs to provide these Divisions with expertise in inspections and regulations of those Divisions. During the review, we learned that notwithstanding the fact that noncompliance with the conditions and representations in exemptive orders and no-action letters could result in significant violations of the securities laws, OCIE and the Divisions do not view the granting of exemptive and no-action relief, per se, as a substantial noncompliance risk because of the self-executing nature of the relief granted. A sample of examination reports reviewed in our review, however, revealed numerous instances in which OCIE examinations found deficiencies in compliance with conditions and

representations in exemptive orders and no-action letters. The review found that, despite the noncompliance noted, OCIE's present risk-rating system does not incorporate the issuance of exemptive orders or no-action letters as per se risk factors. Therefore, the review determined that the Divisions and OCIE could identify areas of exemptive and no-action relief to consider as potentially significant risks.

Summary of Recommendations. The report makes five recommendations that are intended to enhance the Commission's oversight of compliance with conditions and representations in exemptive orders and no-action letters: (1) the Divisions of Investment Management, Trading and Markets, and Corporation Finance should develop processes for coordinating with OCIE regarding reviewing for compliance with conditions and representations in exemptive orders and no-action letters issued to regulated entities on a risk basis; (2) the Divisions of Investment Management, Trading and Markets, and Corporation Finance, in coordination with the Office of Information Technology and OCIE, should develop and implement processes to consolidate, track, and analyze information regarding exemptive orders and no-action letters; (3) the Divisions of Investment Management and Trading and Markets should, in their plans for implementing the Dodd-Frank Wall Street Reform and Consumer Protection Act requirement that they establish their own examination staffs, develop procedures to coordinate their examinations with OCIE and include provisions to review for compliance with conditions and representations in exemptive orders and no-action letters on a risk basis; (4) the Divisions of Investment Management and Trading and Markets should include compliance with the conditions and representations in significant exemptive orders and/or no-action letters issued to regulated entities as risk considerations in connection with their monitoring efforts; and (5) OCIE should include compliance with conditions and representation in significant exemptive orders and no-action letters issued to regulated entities as risk considerations in connection with its compliance efforts.

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Background and Objective

Background

Exemptive Orders

The U.S. Securities and Exchange Commission's (SEC or Commission) general exemptive authority is found in several different statutes administered by the SEC. Section 28 of the Securities Act of 1933 (Securities Act), Sections 12(h) and 36 of the Securities Exchange Act of 1934 (Exchange Act), Section 6(c) of the Investment Company Act of 1940 (Investment Company Act), and Section 206A of the Investment Advisers Act of 1940 (Advisers Act) all provide, using similar wording, for exemptions of persons, securities, or transactions from provisions of law, rules, or regulations.

Section 28 of the Securities Act provides that "[t]he Commission, by rule or regulation, may conditionally or unconditionally exempt any person, security, or transaction, or any class of persons, securities, or transactions, from any provision or provisions of this title or of any rule or regulation issued under this title, to the extent that such exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors."[3]

Section 12(h) of the Exchange Act states that "[t]he Commission may by rules and regulations, or upon application of an interested person, by order, after notice and opportunity for hearing, exempt in whole or in part any issuer or class of issuers from the provisions of subsection (g) of this section or from section 13, 14, or 15(d), or may exempt from section 16 any officer, director or beneficial owner of securities of any issuer, any security of which is required to be registered pursuant to subsection (g) hereof, upon such terms and conditions and for such period as it deems necessary or appropriate, if the Commission finds, by reason of the number of public investors, amount of trading interest in the securities, the nature and extent of the activities of the issuer, income or assets of the issuer, or otherwise, that such action is not inconsistent with the public interest or the protection of investors."

Section 36 of the Exchange Act states that "the Commission, by rule, regulation, or order, may conditionally or unconditionally exempt any person, security, or transaction, or any class or classes of persons, securities, or transactions, from any provision or provisions of this title or of any rule or regulation thereunder, to the extent that such exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors."

[3] Unlike the other statutes referenced, the Securities Act does not provide authority for exemptions through orders, but only by rule or regulation.

Section 6(c) of the Investment Company Act states that "[t]he Commission, by rules and regulations upon its own motion, or by order upon application, may conditionally or unconditionally exempt any person, security, or transaction, or any class or classes of persons, securities, or transactions, from any provision or provisions of this title or of any rule or regulation thereunder, if and to the extent that such exemption is necessary and appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of this title."

Section 206A of the Advisers Act provides that "[t]he Commission, by rules and regulations, upon its own motion, or by order upon application, may conditionally or unconditionally exempt any person or transaction, or any class or classes of persons, or transactions, from any provision or 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 this title."

In addition, Section 304(d) of the Trust Indenture Act of 1939 provides that "[t]he Commission may, by rules or regulations upon its own motion, or by order on application by an interested person, exempt conditionally or unconditionally any person, registration statement, indenture, security or transaction, or any class or classes of persons, registration statements, indentures, securities, or transactions, from any one or more of the provisions of this title, 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 this title."

During hearings before a subcommittee of the U.S. House of Representatives Committee on Interstate and Foreign Commerce on H.R. 10065, a bill to provide for the regulation of investment companies and investment advisers, an SEC counsel told Congress that the proposed Section 6(c) of the Investment Company Act "empowers the Commission to exempt any person or transaction if it is not inconsistent with the purpose of the title."[4] At Senate subcommittee hearings on the same topic, the SEC counsel further explained the rationale behind the Section 6(c) exemptive provision by stating, in part, "You cannot possibly anticipate a transaction which you feel should not come within any specific provision of this bill, and you cannot possibly anticipate any person who may or may not come within the specific provisions of this bill. . . . If conditions exist or arise which manifestly are not within the legislative intent of this legislation, then the Commission should be in a position to exempt those in that

[4] Statement of David Schenker, Chief Counsel, Investment Trust Study, Securities and Exchange Commission, at the Hearings Before a Subcommittee of the Committee on Interstate and Foreign Commerce, House of Representatives, on H.R. 10065 (June 13-14, 1940), at 106.

situation, and the industry should not be required to go to Congress to get a statutory enactment to meet that specific situation."[5]

The legislative history of the Investment Company Act Amendments of 1970 explained that proposed Section 206A of the Advisers Act "would be the counterpart of [S]ection 6(c) of the Investment Company Act, which gives the Commission broad power to exempt any person, transaction, or security from any provision of that statute. The flexibility which this amendment would introduce into the administration of the Advisers Act is appropriate in view of the broader coverage provided for by this bill."[6] With respect to Section 28 of the Securities Act, the exemption was added to allow "the Commission enhanced flexibility to more easily adopt new approaches to registration, disclosure, and related issues . . . . The Committee [on Commerce of the House of Representatives] expects that the Commission will use this authority to promote efficiency, competition and capital formation in the marketplace, consistent with the public interest and investor protection."[7] In addition, Section 36 was added to the Exchange Act to "promote efficiency, competition and capital formation in the marketplace, consistent with the public interest and investor protection."[8]

The Commission, acting by order, issues exemptions from statutory provisions and Commission rules upon its own motion or pursuant to applications from market participants. In some cases, these orders are issued by the staff acting pursuant to delegated authority. The Division of Investment Management (IM) provides exemptive relief under the Investment Company Act and the Advisers Act to regulated entities, including investment companies and investment advisers. The Division of Trading and Markets (TM) provides exemptive relief pursuant to the Exchange Act to entities, including regulated entities such as broker-dealers and exchanges, as well as for certain market activities. The Division of Corporation Finance (CF) provides exemptive relief under the securities registration and reporting sections of the Exchange Act to companies with outstanding securities that may otherwise be subject to such sections, which could include certain regulated entities. These three divisions may coordinate on exemptive relief regarding cross-cutting issues—for example, auction rate securities.[9] Assessment of compliance by regulated entities with the conditions and representations in exemptive orders and no-action letters[10] is conducted

[5] Further Statement of David Schenker, Counsel for the Investment Trust Study, Securities and Exchange Commission, at the Hearings of the Subcommittee of the Committee on Banking and Currency, United States Senate on S. 3580 (Apr. 2-5 and 8-10, 1940), at 197.
[6] Report of the Committee on Banking and Currency, United States Senate, to Accompany S. 3724 (July 1, 1968) at 45.
[7] Report No. 104-622 of the House of Representatives Committee on Commerce, on the Securities Amendments of 1996 (June 17, 1996).
[8] *Id.*
[9] *See, e.g.*, Responses of the Office of Mergers and Acquisitions, Division of Corporation Finance, the Division of Trading and Markets and the Division of Investment Management, *Auction Rate Securities -- Global Exemptive Relief (*Sep. 22, 2008).
[10] See pp. 7 to 13 below for a discussion of no-action letters.

primarily by the Office of Compliance Inspections and Examinations (OCIE) as part of its inspection and examination activities.

However, exemptive relief was not intended to provide unrestricted or unlimited relief from securities laws and rules. For example, the Commission noted the following in a July 15, 1960, Formal Opinion regarding the general exemptive authority under the Investment Company Act: "[T]he exceptional power under Section 6(c) to free any person from any or all provisions of the [Investment Company] Act is one which must be exercised with circumspection and with full regard to the public interest and the purposes of the [Investment Company] Act . . . ."[11] According to the SEC's website, in order to provide exemptive relief under Section 36 of the Exchange Act, "the Commission must determine that the exemption is necessary or appropriate in the public interest and is consistent with the protection of investors."[12] While the Commission may provide unconditional exemptive relief, the exemptive relief granted by the Commission typically requires compliance with certain conditions. If the SEC grants an application for an exemption that contains conditions, the requestor must adhere to the conditions of the exemptive order issued by the Commission or a Division acting pursuant to delegated authority in order for the exemption to have any effect.

A 2005 staff report to the Commission described the role of conditions in exemptive relief. According to the IM report,

> Congress granted broad authority to the Commission to provide exemptions, conditionally or unconditionally, from the [Investment Company] Act, when the exemptions are in the public interest and consistent with the protection of investors and the purposes of the [Investment Company] Act. Since 1940, the Commission has adopted a variety of exemptive rules that permit otherwise prohibited transactions, but only under certain conditions . . . that help to deter overreaching by fund managers and protect the interests of fund investors.
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> The exemptive rules permit certain activities only under conditions that are designed to help ensure that funds and their investors are adequately protected from the risks posed by the conflicts of interest. Some of the conditions that the Commission has included as a part of its exemptive orders and rules include [Independent Legal Counsel, Independent Bidding Process, Separate Advisory

[11] *In re The Great American Life Underwriters, Inc.*, File No. 811-423 (July 15, 1960) at 5 (footnote omitted).
[12] "Exchange Act Exemptive Applications," www.sec.gov/rules/exempt.shtml.

and Broker-Dealer Operations, Limits on Control and Audit Reports].[13]

Exemptive orders allow entities to engage in transactions that would otherwise be prohibited by the provisions from which relief was requested. Noncompliance with the conditions of an exemptive order negates the ability of the recipient to rely on the exemption, and may result in a violation of the applicable securities laws or regulations. According to senior management staff in IM, CF, TM, and OCIE, noncompliance with the conditions of exemptive orders renders the order inapplicable to the transaction for which the relief was requested, and the order will be treated as if it did not exist.

The following are examples of exemptive orders, including the conditions thereto, that were issued by the Commission, or a Division pursuant to delegated authority:

Distributions of Long-Term Capital Gains by Closed-End Investment Companies

An exemptive order was requested "to permit a registered closed-end investment company to make periodic distributions of long-term capital gains with respect to its common shares as often as monthly in any one taxable year, and as frequently as distributions are specified by or in accordance with the terms of its preferred shares."[14] The relief was required because "Section 19(b) of the [Investment Company] Act generally makes it unlawful for any registered investment company to make long-term capital gains distributions more than once every twelve months."[15] The applicant agreed that the requested relief would be subject to a number of conditions, including review and reporting by the fund's Chief Compliance Officer as to whether the fund and its investment adviser had complied with the conditions of the order; disclosures to fund shareholders regarding distributions on a per share basis and other information; and certain disclosures to shareholders, prospective shareholders, and third parties.[16]

Subadvisory Agreements Without Shareholder Approval

A series of funds requested an exemption from Section 15(a) of the Investment Company Act and Rule 18f-2 thereunder to be

[13] Staff Report to the Securities and Exchange Commission, *Exemptive Rule Amendments of 2004: The Independent Chair Condition* (April 2005), pp. 2, 13-14 (footnote omitted).
[14] Investment Company Act Release No. 28938; Evergreen Income Advantage Fund *et al*.; Notice of Application (Sep. 30, 2009), at 1.
[15] *Id.* at 5.
[16] *Id.* at 11-18.

permitted to enter into and materially amend subadvisory agreements without shareholder approval and for relief from certain disclosure requirements.[17] According to Section 15(a) of the Investment Company Act, "it is unlawful for any person to act as an investment adviser to a registered investment company except pursuant to a written contract that has been approved by a majority vote of the company's outstanding voting securities. Rule 18f-2 under the Act provides that each series or class of stock in a series investment company affected by a matter must approve that matter if the Act requires shareholder approval."[18]

The conditions agreed to by the applicants included, but were not limited to, the following:

- The operation of a fund in the manner described in the application will be approved by a majority of the fund's outstanding voting securities before a fund may rely on the order requested in the application, and the prospectus for each fund will disclose the existence, substance, and effect of any order granted pursuant to the application.
- The affected fund's shareholders will be furnished all information about the new subadviser that would be included in a proxy statement within 90 days after hiring a new subadviser, except as modified to permit aggregate fee disclosure.
- The adviser will not enter into a subadvisory agreement with any affiliated subadviser without approval of the agreement, including the compensation to be paid, by the shareholders of the applicable fund.
- At least a majority of the board will be independent board members, and nomination of new or additional independent board members will be placed within the discretion of then-existing board members.
- Each fund will disclose the aggregate fee disclosure in its registration statement.[19]

Nationally Recognized Statistical Rating Organization Conflicts of Interest

The Commission, on May 19, 2010, "conditionally exempted, with respect to certain credit ratings and until December 2, 2010, nationally recognized statistical rating organizations ('NRSROs')

[17] Investment Company Act Release No. 28808; GE Funds *et al.;* Notice of Application (July 2, 2009), at 1.
[18] *Id.* at 5.
[19] *Id.* at 7-12.

from certain requirements in Rule 17g-5(a)(3) under the [Exchange Act] . . . .[20] "The Commission [then extended] the temporary conditional exemption exempting NRSROs from complying with Rule 17g-5(a)(3) with respect to rating covered transactions until December 2, 2011."[21]

According to the Order extending the exemption, "Paragraph (a) of Rule 17g-5 prohibits an NRSRO from issuing or maintaining a credit rating if it is subject to the conflicts of interest identified in paragraph (b) of Rule 17g-5 unless the NRSRO has . . . disclosed the type of conflict of interest in Exhibit 6 to Form NRSRO in accordance with Section 15E(a)(1)(B)(vi) of the Exchange Act and Rule 17g-1. . . and . . . established and is maintaining and enforcing written policies and procedures to address and manage conflicts of interest in accordance with Section 15E(h) of the Exchange Act[]."[22] In December 2009, the Commission adopted Rule 17g-5(a)(3), which "requires an NRSRO that is hired by an arranger to determine an initial credit rating for a structured finance product to take certain steps designed to allow an NRSRO that is not hired by the arranger to nonetheless determine an initial credit rating—and subsequently monitor that credit rating—for the structured finance product."[23]

The Commission extended until December 2, 2011, the exemption from the requirements of Rule 17g-5(a)(3) if the following conditions exist: "(1) The issuer of the security or money market instrument is not a U.S. person . . . ; and (2) The [NRSRO] has a reasonable basis to conclude that the structured finance product will be offered and sold upon issuance, and that any arranger linked to the structured finance product will effect transactions of the structured finance product after issuance, only in transactions that occur outside the U.S."[24]

No-Action Letters

In some instances, instead of exemptive relief from the provisions of the securities laws, a company will request assurances, known as "no-action" letters, from Commission staff that it will not recommend enforcement action for the company's proposed activity. No-action letters expressly represent only a

[20] Release No. 34-63363, Order Extending Temporary Condition Exemption for Nationally Recognized Statistical Rating Organizations From Requirements of Rule 17g-5 Under the Securities Exchange Act of 1934 and Request for Comment (Nov. 23, 2010), at 1 (footnote omitted).
[21] *Id.*
[22] *Id*. at 2 (footnotes omitted).
[23] *Id.* (footnote omitted).
[24] *Id.* at 8.

position by the staff as to whether it would recommend enforcement action to the Commission based on the facts and circumstances described in the incoming letter(s), and the letters expressly do not represent legal conclusions or opinions. No-action letters are intended to assist industry in complying with the securities laws by providing the Divisions' staff positions on contemplated transactions.

The Commission staff provide no-action letters under the Commission's rules pertaining to informal procedures. Rule 202.1(d) provides, in part, as follows:,

> The informal procedures of the Commission are largely concerned with the rendering of advice and assistance by the Commission's staff to members of the public dealing with the Commission. While opinions expressed by members of the staff do not constitute an official expression of the Commission's views, they represent the views of persons who are continuously working with the provisions of the statute involved. And any statement by the director, associate director, assistant director, chief accountant, chief counsel, or chief financial analyst of a division can be relied upon as representing the views of that division.[25]

The Commission is not bound by staff no-action letters, and the letters are not rulings of the Commission or its staff on questions of law or fact.[26] Also, "such letters are not intended to affect the rights of private persons."[27] According to a former SEC Chairman, although the no-action letter has "no binding effect and is of limited legal significance, [the Commission has] found that the bar regards it as an important and useful device. In substance, the 'no-action' letter is a statement by the staff that, on the facts presented to them, they will not recommend that the Commission take any action if the attorney proceeds on the basis of his opinion that the statutes do not prohibit his proposal."[28]

According to a December 1977 Division of Market Regulation (now TM) memorandum,

> An exemption from a Rule is [sic] generally confers greater benefits on the recipient than a no-action position under the Rule though the difference in benefit may be more apparent than real. An exemption is granted pursuant to delegated authority and precludes the Commission from bringing any action under the Rule, assuming that the facts on which the exemption is granted are accurate and

[25] 17 C.F.R. § 202.1(d).
[26] Commission Release No. 33-5691, No-Action and Interpretive Letters—Monthly Publication of List of Significant Letters Issued by the Division of Corporation Finance (Mar. 17, 1976), 41 Fed. Reg. 13682 (Mar. 31, 1976).
[27] *Id*.
[28] Address by Edward N. Gadsby, Chairman, Securities and Exchange Commission, to the Federal Bar Association, *The Approach of the Practitioner to the S.E.C.* (Sep. 17, 1960), p. 3.

> complete. An exemption is also understood to preclude, at least as a practical matter, civil suits by private litigants. A no-action position precludes only this Division from recommending action under the Rule though it is very unlikely, as a practical matter, that the Commission would bring an action in a situation where this Division had taken a no-action position.[29]

In written requests to the Divisions' staff for no-action relief, applicants are to include

(1) information on the proposed activities,
(2) analysis of the particular facts and circumstances involved,
(3) discussion of the applicable laws and rules, and
(4) representations regarding steps they will take in connection with the proposed transaction, such as disclosures or additional processes.

A Division staff member, usually an attorney, reviews the request and, if the request is granted, responds to the applicant, indicating that the staff will not recommend enforcement action to the Commission based on the facts and representations made in the request.

The Division staff clearly state in these letters that no-action relief was provided solely based on the facts and representations presented and that any different facts or conditions might require another conclusion. Also, the Division staff state that the no-action letter refers to the staff's view on enforcement action only and does not express any legal conclusions on the question presented. For example, a CF no-action letter included the following statement: "This position is based on the representations made to the Division in your letter. Any different facts or conditions might require the Division to reach a different conclusion. Further, this response expresses the Division's position on enforcement action only and does not express any legal conclusion on the question presented."[30]

Initially, the Commission did not make no-action letters available to the public. According to a 1968 Commission release, "[i]n the past, neither interpretive letters, no-action letters, nor the inquiries upon which they have been based have generally been made available to the public. In part, this policy has been based upon a belief that a member of the public should be able to obtain the advice of the Commission's staff without fear that information provided to the staff for that purpose might be made public in a manner that might adversely affect his lawful business activities or invade his personal privacy."[31] The Commission

[29] Memorandum to Market Structure and Trading Practices Attorneys, *December 9, 1977, Staff Meeting Guidelines for Granting Exemptions and Taking No-Action Positions* (Dec. 8, 1977), p. 6.
[30] Division of Corporation Finance No-Action Letter, ViewSonic Corporation (Mar. 14, 2008).
[31] Release No. 33-4924, Request for Comments on Whether Staff Interpretative and No-Action Letters Should Be Made Available to the Public (Sep. 20, 1968), at 3.

reconsidered this position in a request for comments on making no-action letters publicly available, stating the following:

> On the other hand, it has been stated that it would seem anomalous that an agency which embraces disclosure as a fundamental philosophy should adopt a flat non-disclosure policy with respect to administrative determinations it generates . . . . [P]ractitioners might find these letters helpful . . . . Further advantage of public disclosure may result from the fact that some persons may be less than candid in purporting to provide the complete and accurate information requested by the staff; if a procedure were adopted by which all requests for no-action and interpretative letters were made public in the form in which received, it is argued that this would be less likely to occur. Another possible advantage of public disclosure might be that of discouraging unnecessary requests. The Commission's staff has been faced with a growing volume of requests and has found it increasingly difficult to devote to each the degree of analysis it deserves. . . . [E]ven full public disclosure may not be considered too high a price to pay for the expert views of the staff on novel questions of law or on the application of existing principles to novel or unusually complex factual situations."[32]

The Commission has made no-action letters available to the public since 1970.

The following are examples of no-action letters issued by staff of the Divisions:

> ***Investment Advisers' Marketing Materials***
>
> IM staff responded to a request for assurances that it would not recommend enforcement action to the Commission under Section 206(4) of the Advisers Act and Rule 206(4)-1(a)(2) thereunder against the requester's investment adviser subsidiaries if they "distribute certain marketing materials to prospective clients and current clients who are not invested in the investment strategy to which the marketing materials relate . . . that show no fewer than five holdings that contributed most positively to a representative account's performance and an equal number of holdings that contributed most negatively to the representative account's performance."[33]
>
> The staff noted that "Section 206(4) of the Advisers Act prohibits investment advisers from engaging in any act, practice, or course of

[32] *Id.* at 3-4 (quotations and footnote omitted).
[33] Division of Investment Management No-Action Letter, The TCW Group, Inc. (Nov. 7, 2008), p. 1.

business that the Commission, by rule, defines as fraudulent, deceptive or manipulative. Rule 206(4)-1(a)(2) under the Advisers Act generally provides that it is a fraudulent, deceptive, or manipulative act, practice, or course of business for any investment adviser to publish, circulate, or distribute any advertisement 'which refers, directly or indirectly, to past specific recommendations of such investment adviser which were or would have been profitable to any person . . . .' Rule 206(4)-1(a)(2), however, does not prohibit an advertisement 'which sets out or offers to furnish a list of all recommendations made by such investment adviser' during the preceding year, provided that the advertisement or the list contains certain specific disclosures about the recommendations."[34]

The IM staff granted the requested no-action relief based upon the applicant's representations, which included the following:

- The calculation "will take into account consistently the weighting of every holding in the representative account that contributed to the account's performance" during the measurement period, and the charts will consistently reflect the results of the calculation.
- The charts' presentation of information and the number of holdings will be consistent from measurement period to measurement period.
- The charts will show no fewer than 10 holdings, including an equal number of positive and negative holdings.[35]

Reporting of Beneficial Ownership Information

In this no-action letter, CF staff stated that CF would not recommend enforcement action to the Commission if the requester and certain of its entities (Qualifying Entities) "report beneficial ownership on Schedule 13G under those circumstances in which they could so report if they were entities of the type identified in Rule 13d-1(b)(1)(ii) under the [Exchange Act]."[36]

The staff noted that the applicants made representations "regarding the comparability of the relevant foreign laws that govern [the requester] and the Qualifying Entities to the U.S. laws governing entities of the type listed in Rule 13d-1(b)(1)(ii)."[37] The staff also

[34] *Id*. at 2 (footnote omitted).
[35] *Id.* at 4.
[36] Division of Corporation Finance No-Action Letter, Orbis Group and certain of its Qualifying Entities (July 16, 2008).
[37] *Id*.

noted the requester's "undertaking to furnish upon request the information that would be required by Schedule 13D."[38]

Broker-Dealer Confirmations

TM staff responded to a request for assurance that TM staff "would not recommend enforcement action under Rules 17a-3(a)(8) and 17a-4 of the [Exchange Act] against [the requester's] broker-dealer customers that depend on [the requester] to transmit confirmations of purchases and sales of securities (the 'Broker-Dealer Participants'), if these Broker-Dealer Participants rely on [the requester] to maintain and preserve such confirmations under Exchange Act Rule 17a-4(i) . . . .[39] According to the no-action letter, "Broker-Dealer Participants currently transmit to [the requester] all of the disclosures included on each electronic confirmation . . . on a transaction-by-transaction basis. Under [a previous no-action letter], Broker-Dealer Participants will provide [the requester] with the types of disclosures that the Broker-Dealer Participant customarily includes on the back of a paper confirmation, and when an electronically-delivered . . . confirmation is sent to a customer, [the requester] will make the applicable disclosures available to the customer via a URL link stamped on the confirmation. Thus, when [the requester] delivers an electronic confirmation . . . , a Broker-Dealer Participant will no longer need to transmit to [the requester] the disclosures customarily provided on the back of a paper confirmation for each confirmation [the requester] issues, because the Broker-Dealer Participant will have previously transmitted this information to [the requester]."[40]

The staff noted that "[u]nder Rule 17a-4(i), the Broker-Dealer Participants will rely on [the requester] to satisfy the requirements of Rule 17a-3(a)(8) to make and keep current a complete copy of each . . . confirmation delivered to a customer, as well as to preserve such confirmations under Rule 17a-4(b)(1)."[41] The staff further noted that the requester "will preserve the confirmations as is required by Rule 17a-4; and that [the requester] and each Broker-Dealer Participant that engages [the requester] as a third party recordkeeper as described in [the incoming] letter will enter into an agreement setting forth the obligations and representations of each party under the arrangement, consistent with the representations contained in [the incoming] letter."[42] The staff then

[38] *Id.*
[39] Division of Trading and Markets No-Action Letter, Omgeo LLC (Mar. 19, 2009), at 1.
[40] *Id*. at 2.
[41] *Id.*
[42] *Id.*

> stated, "We also note that each Broker-Dealer Participant is required by Form BD to promptly notify regulators of any third party books and records maintenance requirements. Finally, we note that [the requester] has made the representations and agreements required by Rule 17a-4(i)."[43]

Monitoring Conditions of Exemptive Orders and Representations in No-Action Letters

OCIE conducts examinations of firms that are registered with the Commission, including registered broker-dealers, transfer agents, clearing agencies, investment advisers, and investment companies (regulated entities). During examinations, OCIE staff seek to determine whether an entity's activities are conducted in accordance with the federal securities laws. According to OCIE, it has been a longstanding practice for examiners to review, as part of pre-examination work, exemptive orders and no-action letters that have been issued to the registrant being examined. During an examination, examiners may review for compliance with the conditions of any applicable exemptive orders and no-action letters if they fall within the scope of the examination. OCIE indicated that an examination report or deficiency letter will include the results of OCIE's review of compliance with exemptive orders or no-action letters if potential violations of the law are found.

TM's Office of Market Operations has on occasion reviewed compliance with information technology-related conditions of certain temporary exemptive orders, but does not engage in any systematic monitoring of such orders.

The primary record of exemptive orders and no-action letters is contained on the Commission's website at www.sec.gov. On the website, each Division includes its exemptive orders and no-action letters. TM lists such orders and letters by subject category, chronologically, and alphabetically by entity. The Divisions also maintain various internal systems to track the processing of these orders and letters.

Objective

Objective. This review was conducted as part of our annual audit plan. The objective was to assess the Commission's processes for ensuring adherence to the conditions under which exemptive orders and no-action letters are granted to regulated entities.

[43] *Id*.

Findings and Recommendations

Finding 1: The SEC's Divisions That Issue Exemptive Orders and No-Action Letters Do Not Have a Coordinated Process for Ensuring Adherence to the Conditions and Representations Contained Therein

> TM, IM and CF indicated that they generally do not conduct any monitoring for compliance with the conditions and representations in the exemptive orders and no-action letters they issue. TM and IM believe that it is the responsibility of OCIE to conduct inspections and examinations and rely on OCIE's results. CF indicated that it reviews filings submitted by companies to the Commission, but it does not have the authority to conduct examinations of companies to review compliance with no-action letters and exemptive orders. TM's Office of Market Operations has on occasion reviewed compliance with information technology-related conditions of certain temporary exemptive orders, but does not engage in any systematic monitoring of such orders.

Staff in IM and CF indicated that they do not conduct any monitoring for compliance with the conditions and representations in no-action letters and exemptive orders. IM staff stated that IM did not conduct regular reviews to determine whether applicants complied with the conditions of the exemptions it has granted. IM staff indicated that, in their view, OCIE's on-site examinations and inspections are the primary means to monitor regulated entities' compliance with exemptive orders and no-action letters. CF reviews and issues comments to improve disclosures in filings by publicly held companies (e.g., initial public offering registrations, annual and quarterly reports, tender offer filings, and mergers and acquisition filings). These companies can include both nonregulated entities, such as issuers of securities or Exchange Act registrants, and certain regulated entities. CF staff noted that CF does not have examination authority and does not audit for compliance because exemptive orders and no-action letters are not applicable if the conditions or representations in the orders or no-action letters have not been adhered to, i.e., they are "self-executing." CF staff stated that it is in the applicant's interest to comply with the conditions or representations in exemptive orders or no-action letters because of the

investment made in legal assistance and in negotiating the relief and the conditions during the processing of the application

TM staff stated that TM generally does not review for compliance with exemptive orders and no-action letters. TM staff indicated that the responsibility for compliance with the conditions and representations in exemptive orders and no-action letters is given to the entities themselves. TM staff noted that no-action letters contain a statement that if there is a material change in the facts and circumstances related to the relief sought, the letter no longer applies. However, TM's Office of Market Operations has on occasion conducted reviews of the information technology-related conditions of the temporary exemptive relief provided to certain clearing agencies to allow them to serve as central counterparties for credit default swaps, although it does not engage in any systematic monitoring of such orders. TM staff indicated that this was a unique situation because these inspections were required as one of the conditions of the exemptive relief that was granted. TM staff also indicated that, in their view, OCIE examinations and inspections are the primary means to monitor compliance with exemptive orders and no-action letters.

While there is some monitoring of certain matters involving exemptive and no-action relief (e.g., central counterparty clearing of credit default swaps, securities lending, fund distributions of long-term capital gains), the processes for such monitoring are uneven and do not appear to be coordinated. The following is an example of exemptive and no-action relief provided by the Divisions and monitoring efforts.

Auction Rate Securities. In 2008, TM, CF, and IM granted exemptive and no-action relief to a number of firms to allow them to make offers to buy back auction rate securities (i.e., bonds for which the interest rate is reset on a recurring basis) as agreed to in an enforcement settlement. These firms agreed to buy back these securities, which had been marketed as highly liquid and safe investments, from customers such as individual investors, small businesses, and charities after the market for the securities collapsed, leaving the customers with illiquid securities for which there was no market demand.[44] To purchase these securities, the firms needed relief from a number of requirements, including the tender offer, beneficial ownership, and filing requirements of the Exchange Act and the Investment Company Act. The conditions for this relief included purchasing the securities at no less than par value plus dividends or interest, maintaining the appropriate information on the buybacks, and making that information available to TM, and filing certain forms.[45]

[44] Press Release 2008-81, SEC Enforcement Division Announces Preliminary Settlement With Merrill Lynch to Help Auction Rate Securities Investors (Aug. 22, 2008).
[45] Responses of the Office of Mergers and Acquisitions, Division of Corporation Finance, the Division of Trading and Markets and the Division of Investment Management, Auction Rate Securities—Global Exemptive Relief (Sept. 22, 2008).

TM and CF staff indicated that TM and CF performed little, if any, monitoring of compliance with the conditions and representations relating to the relief granted. IM staff stated that although IM monitored activity in the industry regarding the repurchases of auction rate securities, it did not monitor compliance with the conditions and representations related to the exemptive and no-action relief. TM staff indicated that TM did not perform regular reviews to determine whether the conditions and representations related to the auction rate securities exemptive and no-action relief were being complied with. CF also did not perform regular reviews to determine whether the conditions and representations related to the exemptive and no-action relief were being complied with. CF staff indicated that CF was trying to help resolve the liquidity problem with the auction rate securities and that without the exemptive and no-action relief that allowed modified reporting, companies would have to submit hundreds of filings as they bought back these securities. However, CF staff indicated that CF did not have a regular program for reviewing the filings submitted under the modified reporting conditions (Schedules 13D or 13G or the ownership reports, i.e., Forms 3, 4, and 5). IM staff indicated that IM did not perform regular reviews to determine whether the conditions and representations related to the exemptive and no-action relief were being complied with. However, IM stated that it did generally monitor the auction rate preferred securities market.

According to the Commission's rules, the Director of CF is responsible for administration of the Securities Act, the Exchange Act, and the Trust Indenture Act of 1939, except for matters relating to investment companies registered under the Investment Company Act.[46] The Director of TM is responsible for administration of the Exchange Act "relating to the structure and operation of the securities markets and the prevention of manipulation in the securities markets."[47] The Director of IM is responsible for administration of the Commission's responsibilities under the Investment Company Act and the Advisers Act.[48] The Director of OCIE is responsible for compliance inspections and examinations of regulated entities, including but not limited to exchanges, clearing agencies, brokers, dealers, transfer agents, investment companies, and investment advisers.[49]

After the Divisions or their staff issue exemptive orders and no-action letters to regulated entities, they have no consistent process to determine whether the conditions and representations in the orders and letters are complied with and rely primarily on risk-based OCIE examinations for monitoring. IM and TM staff indicated that they provide input into OCIE's examination process, meeting with OCIE both formally and informally to discuss risk, examination planning, and examination findings. However, the Divisions and OCIE do not view exemptive

[46] 17 C.F.R. § 200.18.
[47] 17 C.F.R. § 200.19a.
[48] 17 C.F.R. § 200.20b.
[49] 17 C.F.R. § 200.19c.

orders and no-action letters per se, as potential risks because of the self-executing nature of the relief granted (see Finding 4).

Overall, our review found that the Divisions focused more on processing and issuing exemptive orders and no-action letters than on monitoring compliance with the conditions and representations in their exemptive orders and no-action letters. We further found that the Divisions have established processes and guidance for the receipt and processing of applications for exemptive orders and requests for no-action letters, but they rely on OCIE to monitor compliance as part of its examinations, and have not developed any monitoring procedures. Moreover, except in a small number of instances, the Divisions appear to rely on the entity obtaining relief to comply with the conditions and representations in the orders and letters. However, the Divisions have provided us with no evidence that companies are able to monitor themselves in this regard.

As noted above, exemptive orders and no-action letters allow industry participants to conduct activities that, without the relief, could result in a violation of the securities laws and regulations and/or an enforcement referral. Also, OCIE provided documentation of instances of noncompliance with the conditions and representations in exemptive orders and no-action letters it found as a result of its examinations (for examples, see Finding 4). Notwithstanding the self-executing nature of the relief, we believe that monitoring is important to ensure compliance with the conditions and representations in exemptive orders and no-action letters. This can be achieved by IM and TM and, to the extent applicable, CF engaging in increased coordination with OCIE's examinations of regulated entities' compliance with the conditions and representations in exemptive orders and no-action letters.

Recommendation 1:

The Divisions of Investment Management, Trading and Markets, and Corporation Finance should develop processes, including written policies and procedures, for coordination with the Office of Compliance Inspections and Examinations regarding reviewing for compliance with conditions and representations in exemptive orders and no-action letters issued to regulated entities on a risk basis.

Management Comments. IM, TM, CF and OCIE generally concurred with this recommendation. See Appendix V for management's full comments.

OIG Analysis. We are pleased that IM, TM, CF and OCIE generally concurred with this recommendation.

Finding 2: Data on Compliance With the Conditions and Representations in Exemptive Orders and No-Action Letters Are Not Effectively Captured, Tracked, and Analyzed

> IM, TM, and CF separately maintain their own data on exemptive orders and no-action letters that they process and issue, but the Divisions do not maintain data on compliance with the conditions and representations associated with those orders and letters.

IM, TM, and CF enter and track data regarding processed exemptive orders and no-action letters in various ad hoc spreadsheets and databases. However, the data that we received in response to our review requests did not include any information on compliance with the conditions and representations in exemptive orders and no-action letters. For example, IM provided us with data that included the company name, the topic of the relief or the securities law or regulation involved, and the dates on which the exemptive application was received and relief was issued, but the data did not contain any information about compliance with the conditions and representations in the order or letter. Similarly, CF provided us with a spreadsheet that included company names, types of relief, and dates issued, but the spreadsheet did not have any information on compliance with conditions or representations in exemptive orders and no-action letters. In addition, the Divisions make available lists of exemptive orders and no-action letters on the Commission's website, by date, company name, and subject category, but the website contains no information about compliance with the conditions or representations in the orders and letters.[50]

OCIE's database tracks information such as the company's name, examination number, dates of fieldwork, examiner's name, and actions taken as a result of an examination. OCIE's system also provides the general review areas where deficiencies were identified (e.g., portfolio management, calculation of net asset value, safety of fund assets) and tracks information on violations by review area. OCIE also includes the results of its review of exemptive orders and no-action letters in its examination reports in instances where noncompliance is found, and provides copies of such reports to the Divisions. Further, OCIE tracks violations of the federal securities laws that it identifies in its inspections and examinations. According to OCIE, failure to comply with an exemptive order or no-action letter that results in a violation of the federal securities laws would be tracked as a

[50] The Divisions noted that Section 210(b) of the Advisers Act prohibits the Commission from publicly disclosing the results of any examination of any investment adviser and that, in general, the Commission keeps nonpublic the results of its examinations.

violation of the specific federal securities law. However, OCIE's systems would not identify the exemptive order or no-action letter at issue or the conditions or representations for which there was noncompliance, or provide any link between such order or no-action letter and the resulting violations of the federal securities laws. As a result, without substantial manual effort, OCIE's database cannot be used to identify the exemptive orders and no-action letters for which there was noncompliance with the conditions and representations of the orders or no-action letters, or to link the noncompliance to the applicable violations of the securities laws and regulations.

In addition, since the Divisions and OCIE maintain their own data, they are separately maintaining information on the same entities. For example, if CF provided exemptive and/or no-action relief to an entity, CF would include the applicable order or letter in its database; if IM or TM provided relief to the same entity, IM or TM would include the entity in its database; and if OCIE conducted an examination of that entity, OCIE would include the information regarding the examination in its own database. While the Divisions and OCIE occasionally share information pertinent to exemptive orders and no-action letters, the process is informal and not systematic. For example, OCIE shares its plans and the results of its examinations with IM and TM. Also, some no-action letters and exemptive orders may be developed jointly between IM, CF, and/or TM, and information may be shared in those instances. However, there is no systematic sharing or capability of sharing information, and each entity maintains its own database and lists that are not shared with the others.

The only evidence we saw of the Divisions' analysis of data on compliance with exemptive orders related to certain particular and individual issues. For example, IM analyzed the results of examinations regarding the securities lending practices of investment companies and, as a result, discontinued providing exemptive relief that would allow securities lending using an affiliated lending agent. IM is considering whether to resume issuing relief to engage in securities lending activities with affiliates and, if so, under what terms and conditions. Also, TM staff provided information regarding the method that TM developed specifically to track the results of examinations of clearing agencies operating as central counterparties for clearing credit default swaps, including compliance with certain conditions of the applicable temporary exemptive orders.

Because the Divisions do not systematically capture and analyze data on compliance with the conditions and representations in exemptive orders and no-action letters, we determined that the Commission is less effective than it could be in monitoring compliance with such conditions and representations. For example, the SEC cannot readily identify the regulated entities that have failed to comply with the terms and conditions of the exemptive and/or no-action relief that has been provided to them. Also, the SEC does not perform analyses, for example, to identify the provisions of the securities laws and rules for which exemptive or no-action relief is most often provided or to identify patterns of

noncompliance with the conditions and representations in exemptive orders or no-action letters, such as the investor protection conditions for which noncompliance is most often found. As a result, the SEC is less effective than it could be in monitoring compliance with the investor protection conditions of the relief it provides to the industry from the provisions of the securities laws and rules.

Furthermore, because of the manner in which the data are maintained, there is no single place in the SEC from which it is possible to obtain a combined list of a company's exemptions and no-action relief or the results of any reviews of compliance with the conditions or representations in exemptive orders and no-action letters. For example, the OIG had to review separate no-action and interpretive letter listings for each of the Divisions that were found on the Commission's public website to determine whether companies had received letters from more than one SEC Division.

Recommendation 2:

The Divisions of Investment Management, Trading and Markets, and Corporation Finance, in coordination with the Office of Information Technology and the Office of Compliance Inspections and Examinations, should develop and implement processes to consolidate, track, and analyze information regarding exemptive orders and no-action letters issued to regulated entities. These processes should be documented in written policies and procedures.

Management Comments. IM, TM, CF and OCIE generally concurred with this recommendation. See Appendix V for management's full comments.

OIG Analysis. We are pleased that IM, TM, CF and OCIE generally concurred with this recommendation.

Finding 3: The Organizational Structure of the Regulatory Programs Separates the Issuance of Exemptive and No-Action Relief From Compliance Monitoring

> The SEC organizational structure separates the functions of issuing exemptive and no-action relief from compliance monitoring. IM, TM, and CF and their staffs grant exemptive and no-action relief. OCIE, through its inspections and examinations, reviews for compliance with the conditions and representations in exemptive orders and no-action letters issued to regulated entities. Consequently, the rulemaking Divisions do not view compliance monitoring as their responsibility.

The SEC's organizational structure separates the rulemaking and examination functions. As previously discussed, the rulemaking functions are located in IM, TM, and CF. These Divisions are responsible for overseeing their respective areas of the securities laws and regulations and drafting and proposing rules.

According to 17 C.F.R. § 200.20b, the Director of IM

> is responsible to the Commission for the administration of the Commission's responsibilities under the [Investment Company Act and the Advisers Act] . . . with respect to matters pertaining to investment companies registered under the Investment Company Act . . . and pooled investment funds or accounts, the administration of all matters relating to establishing and requiring adherence to standards of economic and financial reporting and the administration of fair disclosure and related matters under the [Securities Act and the Exchange Act] . . . . These duties shall include inspections arising in connection with such administration but shall exclude enforcement and related activities under the jurisdiction of the Division of Enforcement.

According to 17 C.F.R. § 200.19a, the Director of TM

> is responsible to the Commission for the administration and execution of the Commission's programs under the [Exchange Act] relating to the structure and operation of the securities markets and the prevention of manipulation in the securities markets. These responsibilities include oversight

> of the national market system, the national clearance and settlement system, and self-regulatory organizations, such as the national securities exchanges, registered securities associations, clearing agencies, the Municipal Securities Rulemaking Board, and the Securities Investor Protection Corporation. . . . The functions involved in the regulation of such entities include reviewing proposed rule changes of self-regulatory organizations, recommending the adoption and amendment of Commission rules, responding to interpretive, exemptive, and no-action requests, and conducting inspections, examinations, and market surveillance.

According to 17 C.F.R. § 200.18, the Director of CF

> is responsible to the Commission for the administration of all matters (except those pertaining to investment companies registered under the Investment Company Act . . .) relating to establishing and requiring adherence to standards of business and financial disclosure with respect to securities being offered for public sale pursuant to the registration requirements of the Securities Act . . . or the exemptions therefrom . . . .

TM does have some oversight functions that may pertain to compliance with the conditions and representations of exemptive orders and no-action letters. For example, it oversees the implementation of the Commission's Automation Review Policy program regarding the Self-Regulatory Organizations' system capacity and assessment, notification of system outages, annual reports on systems, and independent reviews.[51] The Automation Review Policy program coordinated with OCIE in the reviews of the central counterparties for clearing credit default swap transactions, conducting its own limited reviews of compliance with the automation-related conditions of the applicable exemptive order, but did not conduct any systematic monitoring. TM has advised us that it views OCIE as being the office with the primary responsibility for monitoring compliance with exemptive orders and no-action letters.

According to 17 C.F.R. § 200.19c, the Director of OCIE "is responsible for the compliance inspections and examinations relating to the regulation of exchanges, national securities associations, clearing agencies, securities information processors, the Municipal Securities Rulemaking Board, brokers and dealers, municipal securities dealers, transfer agents, investment companies, and investment advisers . . . ." Since OCIE inspects and examines regulated entities including investment companies, investment advisers, and broker dealers,

[51] SEC OIG, *Oversight of SRO Automation*, Report No. 268 (May 18, 1998).

OCIE's inspection and examination results are relevant to rules and requirements related to IM's and TM's programs. While IM and TM staff receive copies of OCIE's examination reports, they only coordinate with OCIE on reviews of the implementation of certain major Commission initiatives related to exemptive orders, such as securities lending, NRSROs, and central counterparties for clearing credit default swaps. Our review found that OCIE provides little systematic monitoring for IM, TM, or CF, although CF staff indicated that they receive quarterly reports from OCIE regarding compliance with the nonpublic offering rules. Furthermore, while IM and TM provide some input to OCIE's examination program, OCIE selects its examinations based on its own risk assessment procedures and has its own priorities for selecting entities for examinations and inspections.

Our review found that there is no formalized coordination between the SEC's rulemaking and examination functions and, as a result, there is no formalized process for monitoring or ensuring compliance with the conditions and representations in exemptive orders and no-action letters.

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act) requires IM and TM to include examiners in those Divisions who will report to the Directors of IM and TM.[52] According to legislative history for this provision, the purpose of this requirement was to "provide each Division internally with experts in inspections and in the regulations of that Division, who are closely acquainted with and have access to the staff who write and interpret those regulations."[53]

Recommendation 3:

The Divisions of Investment Management and Trading and Markets should, in their plans for implementing Section 965 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, develop procedures to coordinate their examinations with those conducted by the Office of Compliance Inspections and Examinations and, as appropriate, include provisions for reviewing for compliance with the conditions in exemptive orders and representations made in no-action letters on a risk basis.

Management Comments. IM and TM generally concurred with this recommendation. See Appendix V for management's full comments.

OIG Analysis. We are pleased that IM and TM generally concurred with this recommendation.

[52] Section 965 of the Dodd-Frank Act, Pub. L. No. 111-203 (July 21, 2010)
[53] Senate Report 111-176, The Restoring American Financial Stability Act of 2010, April 30, 2010, at 143.

Finding 4: Exemptive and No-Action Relief Are Not Considered Risk Factors in the Selection of Firms for OCIE Examinations

> The staffs of the Divisions and OCIE do not view the granting of exemptive or no-action relief as, per se, a significant risk factor, although the relief allows entities to conduct activities that are otherwise contrary to the securities laws and regulations, and OCIE has often identified problems with entities' compliance with the conditions of the relief granted.

The OCIE and Division staff we interviewed acknowledged that noncompliance with the conditions and representations in exemptive orders and no-action letters could result in significant violations of the securities laws and/or OCIE referrals to the Division of Enforcement. Also, OCIE provided us with documentation of noncompliance with the conditions and representations in exemptive orders and no-action letters that it found during its examinations. Yet OCIE and the Divisions do not view the granting of exemptive and no-action relief, per se, as a potentially significant noncompliance risk.[54]

OCIE has documented that firms sometimes fail to comply with the conditions of exemptive orders and representations made in requesting no-action relief. OCIE has, through its examinations, identified instances where the conditions and representations in exemptive orders and no-action letters have not been followed. OCIE provided us with information on a total of 477 examination reports that included a discussion of whether or not firms complied with the conditions and representations in exemptive orders or no-action letters. Based on the information provided by OCIE, these 477 examinations represented approximately 10 percent of the 4,771 examinations completed from January 1, 2008, through March 31, 2010. We reviewed a judgmental sample of 72 of the 477 examination reports to determine the types of deficiencies that OCIE identified regarding compliance with the conditions and representations in the exemptive orders or no-action letters. In 44 of these 72 examination reports, we noted that OCIE found deficiencies in compliance with conditions and representations in the exemptive orders or no-action letters.[55]

[54] Division staff stated that they believe that, generally, the more compliance-oriented market participants seek exemptive or no-action relief.

[55] When examiners find that an entity is not in compliance with the stated conditions and representations of an exemptive order or no-action letter on which it purports to rely, they will consider whether the failure constitutes a violation of the securities laws and, if so, they will provide the entity with a deficiency letter or consider referring the matter to the Division of Enforcement.

The following are examples of noncompliance that we identified in our sample of OCIE examination reports:[56]

1. In 2005, the examination staff issued a deficiency letter, noting, "among other things, that Applicants had failed to adhere to representation number eight as outlined in the notice of the filing of [their] application for exemptive relief, seeking an exemption from Section 17(a) of the Investment Company Act and an order permitting certain transactions under Section 17(d) of the Investment Company Act and Rule 17d1 thereunder. During the current examination, the examination staff found that the Fund's Board's failure to conduct a particular review no less frequently than annually was inconsistent with representation one made in the Applicants' request for an exemptive order."

2. "[T]he Funds' analysis that they could rely on [a 1996 Exemptive] Order and [previous no-action letters] . . . ,without going back to the staff, appears to be problematic because the details of their current securities lending activities do not seem to comport with the details of the exemptive application for the 1996 Order or the [no-action letters]. [Footnote omitted.]"

3. "In a no-action letter . . . , staff from [IM] took the position that the presentation of performance data without certain accompanying disclosures may be misleading and, therefore, in violation of Rule 206(4)-1(a)(5). . . . [The examination staff] noted the performance information contained in the prospective client information packet [footnote omitted] did not contain all disclosures as suggested in the [referenced] no-action letter. Registrant's omission of material facts and apparent failure to make clear and meaningful disclosures about the performance results may be inconsistent with [the no-action letter] and therefore may violate Rule 206(4)-1(a)(5)."

4. "[T]he Registrants obtained an exemptive order [parenthetical omitted] that set forth conditions under which [they] could jointly invest in portfolio companies alongside [the adviser's] other fund clients. [Footnote omitted.] Such co-investments would otherwise be prohibited under Section 57(a)(4) and Rule 17d-1 of the [Investment Company] Act. . . . It does not appear that the Adviser is complying with all exemptive order conditions, or with contract provisions pertaining to co-investments."

[56] OCIE has informed us that follow-up efforts have been made with respect to the specific examples of noncompliance that we identified in our review and all of the noted deficiencies have been addressed and remedied.

5. "In a SEC no-action letter . . . IM took the position that registered investment companies may lend their portfolio securities if certain guidelines are met. One guideline states that lending securities does not relieve funds of their fiduciary duty to vote proxies and that funds may have to recall lent securities to satisfy that duty. . . . [T]he Funds['] failure to fulfill their proxy voting responsibilities does not appear to conform with the . . . [no-action letter] guidance . . . . Furthermore, [the examination staff] found that the Funds participating in securities lending have not included the disclosures described in [a subsequent] no-action letter . . . ."

6. "Rule 502 of Regulation D precludes an issuer or any person acting on an issuer's behalf from offering or selling securities by any form of general solicitation or general advertising . . . . In determining what constitutes a general solicitation [CF] has underscored the existence and substance of prior relationships between the issuer or its agent and those being solicited. . . . [T]he staff notes that the no-action letter guidance regarding pre-existing substantive relationships refers to relationships formed prior to the offer, not prior to the investment. [Footnote omitted.] . . . Registrant's participation in a club for accredited investors and Registrant's communications about specific offerings to persons previously unknown to Registrant do not appear to be compliant with the provisions of Rule 502(c) of Regulation D and the Commission's interpretive guidance regarding permitted methods of solicitations. [Footnote omitted.]"[57]

7. A Commission no-action letter "states that, 'Transactions in blank check company securities by their promoters or affiliates, especially where they control or controlled the float of freely tradable securities, are not the kind of ordinary trading transactions between individual investors of securities already issued that Section 4(1) [of the Securities Act] was designed to exempt. . . . The letter further explains that [Commission] Rule 144 is not available as an exemption from registration because such transactions appear to be designed to distribute the securities, and any distribution would require registration. . . . By failing to conduct a reasonable inquiry pursuant to Rule 144(g)(4) to determine if [particular] transactions were part of a securities distribution, [the registrant] may have violated Section 5 of the Securities Act for facilitating [an] unregistered distribution."[58]

[57] The Divisions noted that, in this instance, the regulated entity had failed to comply with Regulation D under the Securities Act, and that the referenced no-action letter had not created any special or additional conditions.

[58] The Divisions pointed out that the referenced no-action letter described how to comply with Rule 144 under the Securities Act, but did not add any special conditions.

8. "The securities lending program for the Funds . . . enables participating portfolios of the Funds to generate additional income by lending equity or fixed income securities to the approved borrowers. . . . These arrangements, and similar arrangements administered by other predecessor affiliates, have been exempted from Section 17(a) and Rule 17d-1 of the [Investment Company] Act by exemptive orders issued by the Commission. In applying for this exemption for [certain funds], [the Registrants'] predecessor firms represented that . . . [they] will reallocate or terminate loans as necessary to enable a Lending Fund to vote its portfolio securities. [Emphasis, citation, and quotations omitted.] . . . The Registrants' practice of not recalling loaned securities to vote proxies appears to have contradicted the provisions of [the exemptive order] during the time period that the Registrants were relying on this exemptive order."

9. A condition of an exemptive order provided that neither a trust nor any fund would be advertised or marketed as open-end funds or mutual funds. The examination staff noted that a statement in a marketing presentation of the Registrant "appears to conflict with [this] condition of the [previous] Order" and a similar provision of a subsequent modified order.

10. The Registrant had filed an application with IM for an exemptive order under various sections of the Investment Company Act. "During the staff's pre-examination work, the staff learned that the Exemptive Application had not yet been approved by the Division. The staff also learned that even though the Exemptive Application had not yet been approved, [the Registrant] has been operating as if the Exemptive Application had been approved by the SEC . . . . For these reasons, [the Registrant] has not made any regulatory filings with the SEC since 2002."

According to the Commission's Performance and Accountability Report for Fiscal Year 2010, "[t]he agency's risk-based [national examination] program is designed to focus resources on those firms and practices that have the greatest potential risk of securities law violations that can harm investors."[59] For example, OCIE "is increasingly utilizing a risk-based inspection strategy that relies on a variety of data points to determine which entities pose the greater risk to investors."[60] This risk assessment process includes consideration of a number of factors. According to OCIE's February 2011 overview of its examinations, "[t]he staff draws on numerous sources for identifying higher risk registrants and selected areas of focus. Sources include, among other things, tips, complaints, and

[59] SEC, FY 2010 Performance and Accountability Report, p. 42.
[60] SEC, FY 2010 Performance and Accountability Report, p. 14.

referrals; analysis of outlier or aberrational information provided to investors; prior examination findings; significant changes in registrants' business activities; and registrant or registered representative disclosures regarding regulatory and other actions brought against them."[61]

According to a recent OIG report on OCIE's process for selecting regulated entities for review, "OCIE has developed a risk-based methodology that it uses to identify 'high risk' advisory firms and funds that are selected for routine examinations. Using its risk-rating system, OCIE assigns a risk level to each adviser based on: (1) information contained in firms' annual registration filings (Form ADV); (2) assessment made during previous examinations of that entity; and/or (3) staff evaluations or other risk criteria."[62]

This risk-rating system, however, does not include the issuance of exemptive orders or no-action letters as per se risk factors. These areas are excluded even though exemptive orders and no-action letters by their nature allow entities to conduct activities that do not fully comply with securities laws and rules (otherwise, no relief would be needed), and OCIE examination results have shown that entities do not always comply with the conditions and representations in these orders and letters. Neither OCIE nor the Divisions view compliance with the conditions in exemptive orders or the representations in no-action letters, per se, as risk factors. In fact, some staff in OCIE and CF expressed the opinion that entities that have obtained exemptive or no-action relief for an activity present a reduced risk, since they have come forward and invested resources to clear their transactions with the Commission before executing them. We also found that only in rare cases did OCIE focus its examination efforts on an entity's compliance with conditions and representations in exemptive orders or no-action letters. Of the 72 examination reports we reviewed, only 10 included a stated purpose to review such compliance. Yet in 44 of the 72 reports we reviewed that discussed compliance with conditions and representations in exemptive orders or no-action letters, there was significant noncompliance noted.

We are not suggesting that the Divisions and OCIE coordinate to plan reviews of each and every regulated entity that receives an exemptive order or no-action letter. However, the Divisions and OCIE could, in carrying out coordinated monitoring and analysis of compliance with the conditions and representations in exemptive orders and no-action letters, identify areas of exemptive and no-action relief to consider as potentially significant risks.

[61] SEC, OCIE, *Examinations by the Securities and Exchange Commission's Office of Compliance Inspections and Examinations* (February 2011), pp. 2-3.
[62] SEC OIG, *Review of the Commission's Process for Selecting Investment Advisers and Investment Companies for Examinations*, Report No. 470 (Nov. 19, 2009), p.15.

Recommendation 4:

In connection with monitoring efforts, the Divisions of Investment Management and Trading and Markets should include compliance with the conditions and representations in significant exemptive orders and/or no-action letters issued to regulated entities as risk considerations.

Management Comments. IM and TM generally concurred with this recommendation. See Appendix V for management's full comments.

OIG Analysis. We are pleased that IM and TM generally concurred with this recommendation.

Recommendation 5:

In connection with its compliance efforts, the Office of Compliance Inspections and Examinations should include compliance with the conditions and representations in significant exemptive orders and/or no-action letters issued to regulated entities as risk considerations.

Management Comments. OCIE generally concurred with this recommendation. See Appendix V for management's full comments.

OIG Analysis. We are pleased that OCIE generally concurred with this recommendation.

Abbreviations/Acronyms

CF	Division of Corporation Finance
IM	Division of Investment Management
NRSRO	Nationally Recognized Statistical Rating Organization
OCIE	Office of Compliance Inspections and Examinations
OIG	Office of Inspector General
SEC or Commission	U.S. Securities and Exchange Commission
TM	Division of Trading and Markets

Scope and Methodology

Scope. The scope of the review included exemptive orders and no-action letters that were issued by IM, TM, and CF from January 1, 2008, through March 31, 2010. We did not review monitoring of compliance with specific statutory exemptions for which no specific application or request was required. Also, we did not assess waivers from the disqualification provisions of the securities laws provided as part of Enforcement settlements. To obtain information on compliance with conditions and representations in exemptive orders and no-action letters, we requested and reviewed OCIE examination reports issued between January 1, 2008, and March 31, 2010, that included reviews of compliance with the conditions and representations in exemptive orders and no-action letters. We also reviewed five examination reports issued in 2007 that OCIE provided to the OIG. We conducted our fieldwork from April 2010 to August 2010 and from October 2010 to February 2011.

Methodology. The review objective was to assess the Commission's processes for ensuring adherence to the conditions and representations pursuant to which exemptive orders and no-action letters were granted to industry applicants. To address this objective, we interviewed IM, TM, and CF senior staff responsible for setting overall organization policy and procedures for monitoring compliance with exemptive orders and no-action letters, as well as for processing applications for exemptive orders and no-action letters, to identify their processes for ensuring adherence with the applicable conditions and representations and to determine their approaches to monitoring compliance after issuing orders and letters. We requested and reviewed documentation including laws, regulations, and policies and procedures that might provide guidance for monitoring compliance. We also interviewed staff in IM, TM, and CF to discuss monitoring of compliance with exemptive orders and no-action letters in general and to discuss specific examples. OCIE (including the field office examination functions) and the Automation Policy Group in TM were the only organizations that developed examination and review reports. We reviewed a judgmental sample of these examination reports to identify the exemptive orders and/or no-action letter conditions and representations that were reviewed and the conclusions reached, and we discussed our results with the Divisions. We selected a judgmental sample in order to obtain examples of noncompliance with the conditions and representations in exemptive orders and no-action letters to show that entities did not always adhere to those conditions and representations. Because we used judgmental samples, we cannot project the results based on our samples to the entire universe from which the samples were taken.

Management Controls. We reviewed controls that were considered significant within the context of the review objective. Controls significant to our review objective related to those controls that the Commission designed and

implemented to ensure compliance with the conditions and representations in exemptive orders and no-action letters. To review these controls**,** we applied the internal control model published by the Committee of Sponsoring Organizations, which is also the basis for the Government Accountability Office's *Standards for Internal Control in the Federal Government*.[63] According to the Committee of Sponsoring Organizations model, there are three fundamental internal control objectives: effective, efficient operations; reliable financial reporting; and compliance with laws and regulations. Internal control also includes five components: control environment, risk assessment, control activities, information and communication, and monitoring. We interviewed management and staff from OCIE, IM, TM, and CF. We identified and reviewed applicable policies and procedures, and we obtained and reviewed other pertinent documentation. We performed tests to determine the extent of monitoring of compliance with exemptive order and no-action letter conditions and representations. Finally, we identified areas for improvement in management controls related to the control environment, risk assessment, control activities, information and communication, and monitoring.

Use of Computer-Processed Data. We used exemptive order and no-action letter data maintained by the Commission on its website at sec.gov. We used lists of examination reports provided by OCIE to select judgmental samples of reports to review. We did not perform tests on the general or application controls of the Commission's system for maintaining exemptive orders and no-action letters because such tests were not within our review objective or subobjectives. We found discrepancies in some of the data that we received from management, such as missing and incorrect data. Therefore, to the extent practical, we compared the exemptive order, no-action letter, and examination report data we received with the underlying documents.

Judgmental Sampling. We selected a judgmental sample of examination reports that were issued or had disposition dates from January 1, 2008, to March 31, 2010. We selected our judgmental sample of examination reports related to no-action letters from a list of 456 examination reports provided by OCIE. OCIE also provided the OIG, in response to other requests, with 21 examination reports, all of which were reviewed. Our findings applied to the items reviewed and were not extrapolated to the universe from which our samples were obtained.

Prior Coverage. The OIG audited the exemptive application process in IM's Office of Investment Company Regulation (*IM Exemptive Application Processing*, Report No. 408, September 29, 2006) to determine whether the process was timely and to recommend improvements. The OIG report included 13 recommendations. Recommendations to enhance timeliness included issuing

[63] Government Accountability Office, *Standards for Internal Control in the Federal Government*, AIMD-00-21.3.1 (November 1999).

exemptive rules, filing applications electronically, and restricting or eliminating the review of draft exemptive applications. Other recommendations included returning poorly prepared applications, developing standard follow-up procedures, improving performance measures, and revising the database for exemptive applications. IM concurred with and addressed all 13 recommendations, and all the recommendations were closed.

Criteria

Section 28 of the Securities Act of 1933. Section 28 provides general exemptive authority, allowing the Commission to exempt by rule or regulation, conditionally or unconditionally, any person, security, or transaction or any class or classes of persons, securities, or transactions from any provision of the Securities Act, to the extent that the exemption is necessary or appropriate in the public interest and is consistent with investor protection.

Section 12(h) of the Securities Exchange Act of 1934. Section 12(h) provides that "[t]he Commission may by rules and regulations, or upon application of an interested person, by order, after notice and opportunity for hearing, exempt in whole or in part any issuer or class of issuers from the provisions of subsection (g) of this section or from section 13, 14, or 15(d), or may exempt from section 16 any officer, director or beneficial owner of securities of any issuer, any security of which is required to be registered pursuant to subsection (g) hereof, upon such terms and conditions and for such period as it deems necessary or appropriate, if the Commission finds, by reason of the number of public investors, amount of trading interest in the securities, the nature and extent of the activities of the issuer, income or assets of the issuer, or otherwise, that such action is not inconsistent with the public interest or the protection of investors."

Section 36 of the Securities Exchange Act of 1934. Section 36 provides general exemptive authority, except for the provisions regarding government securities brokers and dealers, allowing the Commission to exempt by rule, regulation, or order, conditionally or unconditionally, any person, security, or transaction or any class or classes of persons, securities, or transactions from any provision of the Exchange Act, to the extent that the exemption is necessary or appropriate in the public interest and is consistent with investor protection.

Section 6(c) of the Investment Company Act of 1940. Section 6(c) provides general exemptive authority, allowing the Commission to exempt by rules and regulations upon its own motion or by order upon application, conditionally or unconditionally, any person, security, or transaction or any class or classes of persons, securities, or transactions from any provision of the Investment Company Act or from any Investment Company Act rule, if and to the extent that the exemption is necessary or appropriate in the public interest and is consistent with investor protection and the policy and provisions of the Investment Company Act.

Section 206A of the Investment Advisers Act of 1940. Section 206A provides general exemptive authority, allowing the Commission to exempt by its own motion or by rule, regulation, or order upon application, conditionally or unconditionally, any person or transaction or any class or classes of persons or transactions from any provision of the Advisers Act, if and to the extent that the

exemption is necessary or appropriate in the public interest and is consistent with investor protection and the policy and provisions of the Advisers Act.

17 C.F.R. § 202.1(d). This rule provides the basis for the informal procedures by which SEC staff issue no-action letters. According to this rule, "[t]he informal procedures of the Commission are largely concerned with the rendering of advice and assistance by the Commission's staff to members of the public dealing with the Commission. While opinions expressed by members of the staff do not constitute an official expression of the Commission's views, they represent the views of persons who are continuously working with the provisions of the statute involved."

List of Recommendations

Recommendation 1:

The Divisions of Investment Management, Trading and Markets, and Corporation Finance should develop processes, including written policies and procedures, for coordination with the Office of Compliance Inspections and Examinations regarding reviewing for compliance with conditions and representations in exemptive orders and no-action letters issued to regulated entities on a risk basis.

Recommendation 2:

The Divisions of Investment Management, Trading and Markets, and Corporation Finance, in coordination with the Office of Information Technology and the Office of Compliance Inspections and Examinations, should develop and implement processes to consolidate, track, and analyze information regarding exemptive orders and no-action letters issued to regulated entities. These processes should be documented in written policies and procedures.

Recommendation 3:

The Divisions of Investment Management and Trading and Markets should, in their plans for implementing Section 965 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, develop procedures to coordinate their examinations with those conducted by the Office of Compliance Inspections and Examinations and, as appropriate, include provisions for reviewing for compliance with the conditions in exemptive orders and representations made in no-action letters on a risk basis.

Recommendation 4:

In connection with monitoring efforts, the Divisions of Investment Management and Trading and Markets should include compliance with the conditions and representations in significant exemptive orders and/or no-action letters issued to regulated entities as risk considerations.

Recommendation 5:

In connection with its compliance efforts, the Office of Compliance Inspections and Examinations should include compliance with the conditions and representations in significant exemptive orders and/or no-action letters issued to regulated entities as risk considerations.

Management's Comments

MEMORANDUM

Date: June 28, 2011

To: H. David Kotz, Inspector General
Office of Inspector General

From: Robert Cook, Director, Division of Trading and Markets
Eileen Rominger, Director, Division of Investment Management
Meredith Cross, Director, Division of Corporation Finance
Carlo di Florio, Director, Office of Compliance Inspections and Examinations

Cc: Mary Schapiro
Chairman

Re: Management's Response to the Office of Inspector General's Draft Report, *Oversight of and Compliance With Conditions and Representations Related to Exemptive Orders and No-Action Letters*, Report No. 482 dated May 16, 2011

I. Introduction.

The Divisions of Trading and Markets (TM), Investment Management (IM) and Corporation Finance (CF) and the Office of Compliance Inspections and Examinations (OCIE) submit this memorandum in response to the Office of Inspector General's (OIG) Draft Report No. 482 entitled *Oversight of and Compliance With Conditions and Representations Related to Exemptive Orders and No-Action Letters*, dated May 16, 2011 ("Final Draft Report"). Thank you for the opportunity to respond to the Final Draft Report.

With respect to the five recommendations in the Final Draft Report, you requested that each director indicate whether or not he or she concurs with the recommendation. Each of us generally concurs with all the recommendations. We note that while we generally concur with Recommendation 2, it will require the deployment of significant resources, a factor which could impact its timely implementation.

Before we respond to the individual recommendations below, we would like to provide some background that we believe is important to place the Final Draft Report and our response in context.

II. Rationales for granting relief.

Our rules and statutes acknowledge the need to be able to provide relief in appropriate circumstances. In fact, many of our rules and statutes contain a specific exemptive authority provision that allows market participants to apply for, and for the Commission to grant,

exemptive relief from the provisions of a rule or statute where appropriate. Exemptive relief may be issued by the Commission, or by the staff through delegated authority. Interpretive and no-action letters are issued by the staff and do not bind the Commission.

Exemptive relief may be appropriate in various circumstances. For instance, market participants frequently seek to engage in activity that may be prohibited by a literal reading of the applicable rule or statute. Relief may be granted to such persons pursuant to safeguards that are adopted and implemented by condition or where other safeguards are in place that would render the statutory provision unnecessary, or when the conduct would benefit the market or investors overall (and it otherwise meets the statutory standard for granting relief).

In addition, Commission staff may issue relief where it is unclear whether or how a particular rule or statute would apply to activity in which a market participant wishes to engage. Commission staff sometimes grants relief in those circumstances to provide the market participant greater legal certainty before it proceeds with the activity, even though it is not clear that the participant would violate a rule or statute if it were to engage in that activity.

Finally, Commission staff may issue relief to respond to developments in the securities markets. Securities markets evolve at a fast pace, and sometimes a statute or rule may not contain an exception for a specific product or activity simply because that product or activity was not present or prevalent at the time of the statutory enactment or rulemaking. In that circumstance, a relief request informs the staff of new products and activities and may form the basis of future rulemaking. Moreover, during market crises, limited relief may be necessary to further the protection of investors and to ensure orderly markets. Where appropriate, the issuance of relief with specific conditions can provide greater certainty to market participants as to their responsibilities concerning that product or activity while maintaining important investor protections.

III. Scope of relief.

The effect of any no-action or exemptive relief is limited by the terms of the relief. As a general matter, a market participant can rely on the relief only if the participant complies with the representations made in the request for the relief, and with any terms and conditions imposed in the response. Sometimes, however, relief is granted in situations where the application of a statute or rule is ambiguous; in these cases, the failure to abide by stated terms and conditions would not necessarily mean that the entity relying on the relief is in violation of a law or rule. The Commission staff at times grants no-action relief where the activity does not raise the concerns that the rule or statute is designed to address and the issuance of relief with specific conditions provides greater certainty to market participants as to their responsibilities concerning that activity. Similarly, in those cases, the failure to abide by the conditions and representations is not necessarily a violation of the rule or statute under which no-action relief was given, although it negates the ability of the recipient to rely on the staff position.

Relief also varies with respect to the entities to which it applies. Sometimes, relief applies to a single person or transaction only, while other times, relief applies to multiple persons, transactions and/or activities. For instance, market participants other than the named

applicants may rely on class exemptive letters, or orders, and certain types of no-action letters. Also, many exemptive letters and orders contain future relief provisions that enable market participants that are not named applicants to rely on them. The Commission does not know when market participants rely on class relief unless the market participant informs Commission staff of that reliance, for example, during an examination. And the Commission's ability to determine when a market participant is relying on class relief is further limited by the Commission's lack of examination authority over certain entities, such as issuers that register their securities offerings, but are not otherwise required to register.

IV. Background on examinations.

The staff believes that, in general, market participants that seek no-action or exemptive relief do so because they are attuned to compliance issues and are seeking to conform their activities to the Commission's requirements with respect to the particular transaction or activity. Thus, as a general matter, the staff does not believe that the mere fact that a market participant sought and received no-action or exemptive relief means that the market participant is at a greater risk of violating the federal securities laws and rules than other market participants.

OCIE has primary responsibility at the Commission for examining certain regulated entities for compliance with the federal securities laws. The self-regulatory organizations (SROs) are also responsible for examining their broker-dealer members for compliance with the federal securities laws as well as SRO rules. In addition, the Commission has a robust enforcement program that brings actions against both regulated and unregulated market participants for violations of the federal securities laws.

OCIE conducts examinations of regulated entities, including, among others, registered broker-dealers, transfer agents, clearing agencies, investment advisers, and investment companies ("regulated entities"). OCIE triages risk when allocating its limited examination resources and in determining the scope of a particular examination.

TM, IM, CF and OCIE believe that potential non-compliance with the conditions of a no-action letter or exemptive order does not constitute a greater risk than the failure to comply with the provisions of the statutes and rules administered by the Commission. When conducting an examination, examiners review the areas within the examination's scope with a focus on whether an entity's activity in that area is conducted in accordance with the federal securities laws and rules and, as applicable, SRO rules. Additionally, if a no-action letter or exemptive order has been issued to a registrant and is related to issues within the scope of the examination, examiners typically evaluate compliance with the stated conditions and representations of the no-action letter or exemptive order during the examination. In some cases, registrants rely on exemptive orders or no-action letters given to other entities. In such cases, if OCIE identifies a potential violation or deficiency at a regulated entity, it is incumbent upon the regulated entity to inform the examination staff that it is relying on exemptive or no-action relief and the examination team would then review whether such reliance is appropriate and whether the regulated entity is complying with all conditions required for such relief.

Mr. H. David Kotz
June 28, 2011

As described in the Final Draft Report, OCIE evaluates firms' compliance with the terms of no-action or exemptive relief and has identified instances where firms were not complying with the conditions and representations of exemptive orders and no-action letters. However, it is important to note that if a regulated entity is unable to demonstrate its compliance with all conditions of the relief, the market participant *may or may not* be in violation of the federal securities laws and rules. The entity's activities may be in compliance with the applicable law or rule even if a representation or condition of the letter is not fulfilled.

If OCIE determines that non-compliance with the terms of any exemptive order or no-action letter results in a potential violation of the federal securities laws or rules, OCIE will generally cite the potential violation of the underlying law or rule in a deficiency letter. Depending on the circumstances, the examination staff may refer such matters to the relevant rulemaking division(s) and, if warranted, to the Division of Enforcement for further action.

TM and IM have input into OCIE's examination process. OCIE meets with TM and IM both formally and informally to discuss issues such as risks, examination planning, and examination findings. The examination staff also consults with TM and IM staff regarding issues that may arise during an examination.

Given limited resources and broad program responsibilities, TM and IM have not undertaken to supplement OCIE's examination function by establishing Division-specific programs to examine for compliance with the federal securities laws, or for compliance with the terms and conditions of no-action and exemptive relief. While we support continued and enhanced communication, coordination, and interaction between OCIE and the rulemaking divisions (TM and IM, and, where relevant, CF), we strongly believe that the responsibility to conduct risk-based reviews for compliance with the federal securities laws and rules, as well as with the terms and conditions of no-action letters and exemptive relief, should remain with OCIE given its experience in this role, as well as the potential for conflicting or duplicative examination efforts.

As you note, Dodd-Frank Act Section 965 provides that TM and IM shall establish examination staffs within these divisions. TM and IM are currently in the process of determining how to most effectively implement this provision, particularly in light of existing budgetary constraints. While decisions have yet to be made on the most efficient use of such resources, TM and IM generally expect that their respective examination staffs will be part of integrated examination teams that likely will focus on areas that have been prioritized as representing significant risk.

We appreciate the opportunity to respond to your recommendations and value the results of your assessment. Responses to your recommendations, as set forth in your Final Draft Report, are below.

Mr. H. David Kotz
June 28, 2011

V. Responses to recommendations.

Recommendation 1:

The Divisions of Investment Management, Trading and Markets, and Corporation Finance should develop processes, including written policies and procedures, for coordination with the Office of Compliance Inspections and Examinations regarding reviewing for compliance with conditions and representations in exemptive orders and no-action letters issued to regulated entities on a risk basis.

- TM, CF and IM, in consultation with OCIE, will formalize the process of coordination among OCIE, TM, CF and IM with respect to OCIE's existing risk-based examination program for compliance with the federal securities laws, including its review for compliance with the terms and representations of exemptive orders and no-action letters, to the extent such orders or letters are significant and issued to regulated entities.

Recommendation 2:

The Divisions of Investment Management, Trading and Markets, and Corporation Finance, in coordination with the Office of Information Technology and the Office of Compliance Inspections and Examinations, should develop and implement processes, to consolidate, track and analyze information regarding exemptive orders and no-action letters issued to regulated entities. These procedures should be documented in written policies and procedures.

- We support development by the Commission's Office of Information Technology (OIT) of a system to consolidate and track information regarding no-action letters and exemptive orders issued to regulated entities, but only to the extent that such orders or letters are significant and contingent upon the availability of resources. We agree that a consolidated system to identify relief issued by the various divisions to individual market participants that are registered with the Commission may be a useful tool for OCIE.

- The system should provide a field for comment by the divisions responsible for providing the relief as to whether the facts presented to the staff or the relief granted suggest a risk factor that should be considered by OCIE in examination planning. Our review of the letters issued in the last 3 months suggests that such a field is likely to be used sparingly because, as noted above, in general, exemptive orders and no-action letters are given in situations where the risks of non-compliance either with the provisions of the letter or with the applicable statutory provision or rule are not high.

- Establishing the system is a priority, but may be impacted by resource constraints.

Mr. H. David Kotz
June 28, 2011

Recommendation 3:

The Divisions of Investment Management and Trading and Markets should, in their plans for implementing Section 965 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, develop procedures to coordinate their examinations with those conducted by the Office of Compliance Inspections and Examinations and, as appropriate, include provisions for reviewing for compliance with the conditions in exemptive orders and representations made in no-action letters on a risk basis.

- TM and IM support the development of procedures to facilitate examinations that integrate personnel in those divisions and OCIE examiners into joint examination activities. As noted, any reviews of compliance with conditions and representations of exemptive orders and no-action letters, like the underlying examinations, should be risk-based (and thus, for example, required only for significant orders or letters). Further, such reviews by necessity will be contingent upon the availability of resources. We anticipate that TM and IM likely will have extremely limited examination resources.

Recommendation 4:

In connection with monitoring efforts, the Divisions of Investment Management and Trading and Markets should include compliance with the conditions and representations in significant exemptive orders and/or no-action letters issued to regulated entities as risk considerations.

- It is important to note that Commission staff, such as OCIE, primarily conducts risk-based reviews and examinations for compliance rather than engaging in monitoring efforts.

- TM conducts targeted monitoring for financial and similar risks of certain registrants, but generally does not engage in systematic monitoring of compliance with laws or rules, or with conditions for exemptive or no-action relief. The scope of this activity is limited to the specific risks being monitored. Thus, as a practical matter, such monitoring would not normally cover compliance with the majority of exemptions or no-action letters, as such letters would not be relevant to the specific risks being reviewed. Of course, if during these reviews, the staff is considering matters directly related to a significant no-action letter or exemption, the staff would, as appropriate, take into consideration whether the risk monitoring should include a review for compliance with conditions and representations of that no-action letter or exemption.

- Thus, while we support continued and enhanced communication, coordination, and interaction between OCIE and the rulemaking divisions, we strongly believe that the current responsibility to conduct risk-based reviews for compliance with the federal securities laws and rules, as well as with the terms and conditions of no-action letters and exemptive relief, should remain with OCIE given its experience in this role, as well as the potential for conflicting or duplicative examination efforts.

Mr. H. David Kotz
June 28, 2011

Recommendation 5:

In connection with its compliance efforts, the Office of Compliance Inspections and Examinations should include compliance with the conditions and representations in significant exemptive orders and/or no-action letters issued to regulated entities as risk considerations.

- OCIE supports including consideration of compliance with key conditions and representations in significant exemptive orders and/or no-action letters as risk considerations during its process of selecting and conducting examinations of regulated entities for compliance with the federal securities laws.

OIG Response to Management's Comments

The Office of Inspector General (OIG) is pleased that the Divisions of Trading and Markets (TM), Investment Management (IM), and Corporation Finance and the Office Compliance Inspections and Examinations (OCIE) concurred with all five recommendations in this report. We believe that implementing these recommendations will enhance the Commission's oversight of compliance with conditions and representations in exemptive orders and no-action letters. While the Divisions and OCIE noted resource constraints in their response, particularly associated with Recommendation No. 2, pertaining to tracking and analysis, we maintain that the development of a uniform system to consolidate and track information regarding exemptive orders and no-action letters issued to regulated entities would significantly strengthen the SEC's ability to monitor compliance with the conditions and representations contained therein. We are pleased that the Divisions and OCIE have indicated that establishing this system is a priority.

With respect to Recommendation No. 4, we agree that the primary responsibility for conducting risk-based reviews for compliance with the federal securities laws, as well as with the conditions and representations in exemptive orders and no-action letters issued to regulated entities should remain with OCIE. However, we are also pleased that TM and IM have concurred with the recommendation that they include compliance with conditions and representations in exemptive orders and no-action letters as risk considerations in their reviews of matters as appropriate.

Audit Requests and Ideas

The Office of Inspector General welcomes your input. If you would like to request an audit in the future or have an audit idea, please contact us at

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