SECURITIES AND EXCHANGE COMMISSION

17 CFR Parts 230, 240, 270, and 275

[Release Nos. 33–7383, 34–38190, IC–22478, and IA–1609; File No. S7–4–97]

RIN 3235–AG62; 3235–AH01

Definitions of ''Small Business'' or ''Small Organization'' Under the Investment Company Act of 1940, the Investment Advisers Act of 1940, the Securities Exchange Act of 1934, and the Securities Act of 1933

AGENCY: Securities and Exchange Commission.

ACTION: Proposed rule amendments.

SUMMARY: The Securities and Exchange Commission (''Commission'') is publishing for comment proposed amendments to the definitions of ''small business'' and ''small organization'' that are used in connection with Commission rulemaking under the Investment Company Act of 1940, the Investment Advisers Act of 1940, the Securities Exchange Act of 1934, and the Securities Act of 1933 regarding regulatory requirements applicable to investment companies, investment advisers, exchanges, securities information processors, transfer agents and issuers, and broker-dealers. These definitions are used specifically for purposes of the Regulatory Flexibility Act, which requires the Commission to consider the impact of its regulations on small entities. The Commission is proposing amendments to these definitions to reflect recent changes in the law as well as changes in the securities markets over the past decade, including technological innovations and increased business relationships among participants in the securities industry.

DATES: Comments should be received on or before February 27, 1997.

ADDRESSES: Comments should be submitted in triplicate to Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission, Mail Stop 6–9, 450 Fifth Street, N.W., Washington, D.C. 20549. Comments also may be submitted electronically at the following E-mail address: rule-comments@sec.gov. All comment letters should refer to File Number S7–4–97. This file number should be included on the subject line if E-mail is used. Comment letters will be available for inspection and copying in the Public Reference Room, 450 Fifth Street, N.W., Washington D.C. 20549. Electronically submitted comment letters will be posted on the Commission's Internet web site (http://www.sec.gov).

FOR FURTHER INFORMATION CONTACT:

General: Penelope W. Saltzman, Special Counsel, at (202–942–0915), or Anne H. Sullivan, Senior Counsel, at (202–942–0954), Office of the General Counsel, Securities and Exchange Commission, 450 Fifth Street, N.W., Mail Stop 6–6, Washington, D.C. 20549.

Offices with Particular Responsibility: Thomas M.J. Kerwin, Senior Counsel, Division of Investment Management, (definitions applicable to investment companies and investment advisers) (202–942–0690).

Glenn J. Jessee, Special Counsel, Office of the Chief Counsel, Division of Market Regulation (definitions applicable to brokers, dealers, exchanges, transfer agents and issuers, securities information processors, and broker-dealers) (202–942–0073).

SUPPLEMENTARY INFORMATION: The Commission is requesting public comment on proposed amendments to the definitions of ''small business'' and ''small organization'' set forth in Rule 0–10 [17 CFR 270.0–10] under the Investment Company Act of 1940 [15 U.S.C. 80a–1] (''Investment Company Act''), Rule 0–7 [17 CFR 275.0–7] under the Investment Advisers Act of 1940 [15 U.S.C. 80b–1] (the ''Advisers Act''), Rule 0–10 [17 CFR 240.0–10] under the Securities Exchange Act of 1934 [15 U.S.C. 78a] (the ''Exchange Act''), and Rule 157 [17 CFR 230.157] under the Securities Act of 1933 [15 U.S.C. 77a] (the ''Securities Act'') as those terms are used for purposes of Chapter Six of the Administrative Procedure Act, 5 U.S.C. 601 *et seq.* (the Regulatory Flexibility Act, Pub. L. No. 96–354, 94 Stat. 1164 (1980), as amended, Pub. L. No. 104–121, Title II, Subtitle D, 110 Stat. 864 (1996) (''RFA'')). The RFA requires the Commission to, among other things, consider the impact of Commission rulemaking on entities that qualify as ''small'' under applicable standards set forth in the RFA, the Small Business Act,[1] or regulations promulgated by the Small Business Administration (''SBA'').[2] In 1982, the Commission adopted definitions that it considered appropriate for issuers and other entities subject to its regulation, and the Commission is now, after consultation with the Office of Advocacy of the SBA, proposing for public comment amendments to those definitions applicable to investment companies, investment advisers, exchanges, clearing agencies, transfer agents and issuers,[3] securities information processors, and broker-dealers. The proposed amendments are discussed below.

I. Background

The Commission has a longstanding commitment to understanding and addressing the special concerns of small business. Nearly two decades ago, in 1979, the Commission established the Office of Small Business Policy in the Division of Corporation Finance, whose mission is to direct the Commission's small business rulemaking initiatives, review and comment on the impact of Commission rule proposals on small issuers, and serve as liaison with Congressional committees, government agencies, and other groups concerned with small business. Since then, the Commission has conducted regular reviews of its rules, and their impact on small business, in response to changing market conditions, advances in technology, and innovations in financial products, as well as to determine whether the rules continue to meet appropriate regulatory objectives. These ongoing efforts have resulted in a number of rule proposals or amendments and other initiatives specifically intended to assist small businesses. They include:

- *1992 Small Business Initiative.* In 1992, the Commission undertook a major initiative to make raising capital easier for small businesses, which included the introduction of a new small business integrated disclosure system, increased exemptions permitting unregistered public and private sale of securities, and simplified ongoing periodic reporting requirements of registered small issuers.[4]
- *Mutual Fund Investments.* In 1992, the Commission also published revisions to the Guidelines to Form N–1A relating to mutual fund investments in illiquid securities, a change specifically intended to provide small

[1] 15 U.S.C. 631 *et seq.*

[2] The RFA provides that an agency, after consultation with the Office of Advocacy of the SBA and an opportunity for public comment, may establish one or more definitions of ''small entity'' that are applicable to the activities of the agency. *See* 5 U.S.C. 601(3) and 601(4).

[3] The Commission is not proposing to change the definition of small business issuer, but is proposing to delete the limitation of the definition of small business, as it refers to ''issuer'' or ''person'' under the Exchange Act rules, to Sections 12, 13, 14, 15(d), and 16 of the Exchange Act [15 U.S.C. 78*l*, 78m, 78n, 78o(d), 78p]. *See supra* p. 26.

[4] Securities Act Release No. 6949, 57 FR 36442 (Aug. 13, 1992) (included adopting Regulation S–B, which provided integrated disclosure requirements for small business issuers and simplified the process for registering securities of small business issuers for public sale, amending Regulation A to raise the ceiling for exempt offerings from $1.5 million to $5 million, and adopting Regulation D, which permitted nonpublic companies to raise up to $1 million in 12 months from any number or type of investor without federal registration and disclosure obligations except anti-fraud provisions).

businesses better access to capital markets.[5]

• *New Registration Exemption.* The Commission recently adopted a new exemption from registration requirements for limited offerings of up to $5 million that are exempt from qualification under California law.[6]

• *Fewer Small Businesses Subject to Exchange Act Registration.* The Commission also recently doubled the asset threshold that subjects companies to registration under the Exchange Act from $5 million to $10 million so that fewer small businesses are subject to reporting requirements under the Exchange Act.[7]

• *Pending Initiatives.* The Commission's Task Force on Capital Formation and Regulatory Processes has proposed a number of initiatives to further increase small business access to capital markets, including liberalizing and expanding the local offering exemption and creating a new limited exemption for certain local offerings that cross state lines, expanding the small offering exemption by permitting small businesses to raise $5 million every six months rather than once a year, and permitting companies engaged in certain exempt offerings of $5 million or less to use uncertified financial statements.[8]

In keeping with its attention to small business issues, the Commission acted quickly to implement the RFA after it was enacted in 1980. The Commission published its first semiannual agendas identifying rulemaking proposals that could affect small entities on April 9, 1981 and has regularly published semiannual agenda since then.[9] On June 29, 1981, the Commission published its ten-year plan to evaluate existing rules for their impact on small entities and has since completed all required rule reviews under the RFA.[10] Indeed, the Chief Counsel for Advocacy of the SBA, in its first report regarding the RFA, stated that the Commission's rule review ''epitomizes the initiative that all agencies should be taking in the area.'' [11]

As part of its RFA implementation efforts, in early 1982, the Commission also became the first agency to adopt rules under which entities it regulates would qualify as ''small'' for purposes of the RFA.[12] The RFA defines the term ''small entity'' as a ''small business,'' ''small organization,'' or ''small governmental jurisdiction.'' [13] ''Small business'' under the RFA incorporates the Small Business Size Regulations established by the SBA (''SBA size standards'') [14] under the Small Business Act.[15] The RFA definitions of ''small business'' and ''small organization'' also authorize agencies to establish their own definitions of ''small business'' and ''small organization'' if they determine that specialized definitions are more appropriate to the activities of the agency.[16] After reviewing SBA size standards, the Commission chose to adopt its own definitions of these terms for purposes of Commission rulemaking.[17]

The regulations the Commission adopted in 1982 were, in many ways, more expansive than the statutory definitions of ''small business'' and ''small organization'' in the RFA. Under the RFA, a business is not considered ''small'' if it is not ''independently owned and operated.'' [18] The Commission's definitions go beyond RFA requirements because, for the most part, the Commission's definitions do not limit ''small businesses'' to those that are independently owned and operated. The Commission's existing definitions also are broader in certain respects than the SBA size standards, which consider various limiting factors when determining if an entity is ''small.'' [19] For example, the SBA size standards consider if entities are affiliated by such factors as control, management, ownership, and contractual relationships in determining whether an entity is ''independently owned and operated,'' and thus, ''small.'' [20] In addition, the SBA may treat multiple entities that have identical or substantially identical business or economic interests as a single entity.[21] Although the Commission's definitions in some cases address the concept of control,[22] none of these other affiliation concepts set forth in the SBA size standards is considered in the Commission's definitions of ''small business.''

Under the Commission's existing definitions, which were adopted in 1982, a majority of investment advisers and broker-dealers qualify as small.[23] Many of these ''small'' investment

[5] Revisions of Guidelines to Form N–1A, Investment Company Act Release No. 18612, 57 FR 9828 (Mar. 20, 1992) (permitting mutual funds, other than money market funds, to increase from 10 percent to 15 percent the amount of illiquid assets they may hold).

[6] Securities Act Release No. 7285, 61 FR 21356 (May 9, 1996).

[7] Exchange Act Release No. 37157, 61 FR 21354 (May 9, 1996).

[8] *See* Report of the Task Force on Disclosure Simplification (March 1996).

[9] 46 FR 23942 (Apr. 29, 1981). The Commission first published the semiannual agenda independently. Beginning in October 1982 the Commission included its semiannual agenda in the Unified Agenda of Federal Regulations compiled by the Regulatory Service Information Center. *See* 47 FR 48300, 48988 (Oct. 28, 1982).

[10] 46 FR 33287 (June 29, 1981). The requirements regarding publication of a semiannual agenda and the ten-year rule review are set forth in 5 U.S.C. 602 and 610, respectively.

[11] Oversight of Regulatory Flexibility Act: Hearings Before the Subcomm. on Export Opportunities and Special Small Business Problems of the House Comm. on Small Business, 97th Cong., 1st Sess. 51 (1981) (statement of Frank Swain, Chief Counsel for Advocacy, SBA).

[12] Final Definitions of ''Small Business'' and ''Small Organization'' for Purposes of the Regulatory Flexibility Act, Securities Act Release No. 6380, Exchange Act Release No. 18452, PUHCA Release No. 22371, Trust Indenture Act Release No. 693, Investment Company Act Release No. 12194, Investment Advisers Act Release No. 791, 47 FR 5215 (Feb. 4, 1982) (''1982 Adopting Release''). Other agencies have adopted notices or policy statements respecting their views regarding the definition of ''small business.'' *See, e.g.*, Definitions of Small Entity and Significant Economic Impact for Making Determinations Required by the Regulatory Flexibility Act of 1980, 51 FR 45831 (Dec. 22, 1986) (Federal Aviation Administration, Department of Transportation); Policy Statement and Establishment of Definitions of ''Small Entities'' for Purposes of the Regulatory Flexibility Act, 47 FR 18618 (Apr. 30, 1982) (Commodity Futures Trading Commission).

[13] 5 U.S.C. 601(6).

[14] 13 CFR Part 121.

[15] 5 U.S.C. 601(3) (defining ''small business'' to mean ''small business concern'' under the Small Business Act, 15 U.S.C. 632(a), which in turn allows the SBA to establish standards for determining ''small business concern'').

[16] *Id.* Secs. 601(3), 601(4).

[17] The Commission determined that the industry size standards adopted by the SBA were generally inappropriate in the context of regulations affecting securities issuers and reporting companies. *See* Proposed Definitions of ''Small Business'' and ''Small Organization'' for Purposes of the Regulatory Flexibility Act, Securities Act Release No. 6302, Exchange Act Release No. 17645, PUHCA Release No. 21970, Trust Indenture Act Release No. 619, Investment Company Act Release No. 11694, Investment Advisers Act Release No. 754, 46 FR 19251 (Mar. 30, 1981) (''1981 Proposing Release''); *See also* 1982 Adopting Release, 47 FR at 5216.

[18] A ''small'' entity also cannot be dominant in its field of operation. *See* 5 U.S.C. 601(4) (''small organization'' under RFA means an entity that is ''independently owned and operated and is not dominant in its field''); 15 U.S.C. 632(a)(1) (definition of ''small business concern'' under the Small Business Act (as incorporated in the RFA definition of ''small business,'' 5 U.S.C. 601(3)) means an entity that is ''independently owned and operated and which is not dominant in its field'').

[19] *See* SBA size standards, 13 CFR 121.103 (size eligibility provisions and standards).

[20] *Id.* § 121.103(a)(1) (describing control relationships that constitute affiliation); *id.* § 121.103(a)(2) (describing factors such as ownership, management, previous relationships with or ties to another concern, and contractual relationships that SBA considers in determining whether affiliation exists).

[21] *See id.* § 121.103(a)(3).

[22] In certain definitions of ''small business'' and ''small organization'' under the Exchange Act (broker, dealer, clearing agency, municipal securities dealer, securities information processor, transfer agent), the Commission considers control interests in determining whether the entity is ''small.'' Exchange Act rule 0–10 [17 CFR 240.10]. The SBA regulations also address factors of control. 13 CFR 121.103(a)(1).

[23] Currently, approximately 75 percent of registered investment advisers and 60 percent of registered broker-dealers qualify as ''small.''

advisers handle as much as $50 million in client funds. In addition, some ''small'' broker-dealers handle customer orders in excess of $200 million from which they earn more than $6 million per year in revenue.[24] These entities continue to be classified as ''small'' under Commission rules even though they may be affiliated with larger entities that are responsible for many of the smaller firms' securities functions. For example, today most mutual funds are affiliated with large mutual fund families, and many investment advisers are affiliated with larger financial services firms. These relationships allow the ''small'' affiliates to rely on a larger entity that centralizes administrative and compliance systems for all affiliates, significantly reducing regulatory burdens for each individual affiliate. A similar relationship exists between introducing broker-dealers and the large firms through which they clear securities trades. Although introducing and clearing firms share responsibility for ensuring that a customer's account is handled properly, introducing firms typically depend on clearing firms to execute customer trades, to handle customer funds and securities, and to handle many back-office functions, including issuing the confirmation of the customer's trade. The increase in these affiliations since 1982 occurred along with tremendous growth and significant technological changes in the securities industry that facilitate such arrangements.[25] These changes in the securities industry prompted the Commission to begin reviewing certain of its ''small business'' definitions in 1995.[26]

In March 1996, Congress revisited small business concerns when it enacted the Small Business Regulatory Enforcement Fairness Act of 1996 (''SBREFA'').[27] Among other things, SBREFA imposed new obligations on the Commission and other agencies to assist small entities in understanding and complying with regulatory requirements, including the adoption of small business compliance guides and an informal guidance program for small businesses.[28] In addition, SBREFA amended the RFA to allow small entities to seek judicial review of agency compliance with the RFA.[29] SBREFA also amended the Equal Access to Justice Act (''EAJA'') [30] by expanding the class of litigants eligible to receive EAJA awards to include small entities as defined under the RFA.[31]

After SBREFA was enacted, the Commission began to develop initiatives to meet its new obligations under the Act and to review whether the Commission's definitions of ''small business'' and ''small organization'' are still appropriate in view of (1) changes in the securities industry and (2) the Commission's expanded obligations under SBREFA. [32] As a result of its review, the Commission is proposing amendments to the definitions of these terms as they apply to investment companies, investment advisers, exchanges, securities information processors, transfer agents and issuers, and broker-dealers. The Commission intends to maintain its definitions of ''small business'' as they relate to small business issuers, and other regulated entities. [33] The proposed amendments would take into account more of the factors suggested by SBA size standards in determining whether an entity qualifies as ''small.''

The Commission's proposal to amend certain ''small business'' definitions should be considered in light of the Commission's ongoing efforts to assist small business. On June 4, 1996, the Commission appointed a special ombudsman to serve as the liaison and agency spokesman for the concerns of small business. [34] The Commission also recently held the first in a series of town meetings (to be held nationwide) to educate small business issuers about the many opportunities to raise capital in the securities markets. [35] More generally, the Commission has established a World Wide Web site, which provides, among other things, a special package of information for small businesses, including Commission rulemaking and initiatives affecting small business. [36] The Commission also has established an electronic mailbox to receive comments on Commission rulemaking. [37] These communication efforts supplement the Commission's annual government-business forum on small business capital formation. This forum is held in a different place across the country each year to make attendance by small businesses easier, and it is the only government-sponsored national gathering for small businesses that annually offers small business the chance to tell government officials how the laws, rules, and regulations impact their ability to raise capital. Through these and other efforts, the Commission

[24] The revenue amount is based on information provided by broker-dealers in quarterly FOCUS reports. The amount of customer order flow is derived using revenue data in the FOCUS reports.

[25] Between 1980 and 1995, the value of public offerings (including debt and equity, but not investment company securities) increased from $58 billion to $768 billion. Between 1990 and 1995, the dollar volume of equity securities traded on U.S. securities exchanges and National Association of Securities Dealers Automated Quotation System (''Nasdaq'') grew 182 percent, with over $5.94 trillion traded in 1995. Assets under management by investment advisers (excluding investment advisers to registered investment companies) rose from $205 billion to $7.6 trillion (a 3,607 percent increase) between 1980 and 1995. Over the same period, assets of investment companies increased 1,203 percent from $235 billion to $3.062 trillion. The number of securities firms and professionals registered with the Commission or with self-regulating organizations has also surged. Between 1980 and 1995, the number of registered advisers increased from 3,500 to 22,000 (an increase of 529 percent). The number of broker-dealers grew, over the same period, from around 5,200 to approximately 7,613 (a 46 percent increase). In addition, technological progress has changed the securities industry. For example, advances in information technology have resulted in the proliferation of information vendors and electronic trading systems not contemplated in 1982. Since 1982, the markets have seen the development of fully automated electronic broker-dealers and exchanges, improved electronic order execution systems at broker-dealers, exchanges, and national securities associations, and improved electronic linkages among markets and between broker-dealers and their customers. These changes have created substantially deeper and more liquid markets and have made trading more immediate and less expensive for both institutional and retail customers.

[26] *See* The Regulatory Plan and the Unified Agenda of Federal Regulations, 60 FR 59503, 61073 (Nov. 28, 1995) (Division of Investment Management considering whether to recommend to the Commission to propose amendment of definition of ''small entity'' in Rule 0–10 [17 CFR 270.0–10] under the Investment Company Act).

[27] Pub. L. 104–121, Title II, 110 Stat. 857 (1996).

[28] Id. Secs. 212, 213(b), 110 Stat. 858, 859.

[29] Id. Sec. 242 110 Stat. 865.

[30] 5 U.S.C. 504; 28 U.S.C. 2412.

[31] Pub. L. 104–121, Sec. 232(b)(2), 110 Stat 863.

[32] The Commission is concerned that as a result of the Commission's existing broad definitions of ''small business,'' certain of the amendments made by SBREFA could result in a significant increase in the Commission's exposure to litigation beyond that reasonably contemplated by the RFA. The Commission's enforcement litigation and other litigation matters have increased in recent years. In light of increased exposure to litigation under SBREFA, which could further strain the Commission's limited budget, the Commission believes it is appropriate to consider revising certain definitions of small business to reflect the considerations contained in the definition of the term under the RFA and the SBA size standards.

[33] The Commission does not propose to revise the ''small business'' definitions with respect to clearing agencies, bank municipal securities dealers, or public utility holding company systems. In a separate release, the Commission has, however, proposed conforming changes to the definition of ''small business issuer'' to allow registrants to include non-voting as well as voting common equity, when computing the required $75 million aggregate market value of common equity held by non-affiliates of the registrant.

[34] The Ombudsman is available to receive information from small businesses concerning the impact of any Commission proposal, rule, or regulation and may be contacted at the Division of Corporation Finance's Office of Small Business Policy at (202) 942–2950.

[35] *See* Remarks of Arthur Levitt, Chairman, U.S. Securities and Exchange Commission, Los Angeles Venture Association Town Meeting (Sept. 13, 1996).

[36] The Commission's Web site is located at http://www.sec.gov.

[37] The Commission's address for rulemaking comments is: rule-comments@sec.gov.

will continue to involve small businesses in its rulemaking efforts, in furtherance of the RFA and the Commission's policy of addressing small business concerns.

Although the Commission has worked hard to meet the needs of small businesses, the Commission believes that RFA and SBREFA requirements must be viewed in the context of the requirements of the federal securities laws, which mandate the maintenance of fair, honest, and competitive securities markets and the protection of investors in those markets. As a general matter, the Commission carefully weighs the economic impact of its rules on all regulated entities, including small business. However, the Commission's primary considerations as to each rule it adopts must be the rule's effects on market integrity and investor protection. Thus, uniform rules must be applied to firms that are part of a larger national market system to ensure (1) fair and efficient securities markets and (2) the same level of protection for all investors regardless of the size of the firm to which they entrust their funds. In those situations in which market integrity and investor protection will not be compromised, however, the Commission carefully tailors its regulations to the relevant characteristics of the particular entities regulated.[38] In this way, the Commission works to meet its mandate under the federal securities laws while at the same time reducing costs and regulatory burdens for small business. The Commission intends to continue this careful, measured regulation that addresses small business concerns within the protections of the federal securities laws.

Discussion of Proposed Amendments

A. Investment Companies

Rule 0–10 under the Investment Company Act currently defines ''small business'' or ''small organization'' (together, ''small entity'') to include each investment company (''fund'') that has $50 million or less in assets as of the end of its most recent fiscal year.[39] Thus, the definition focuses only on the fund's own assets.

This approach no longer seems appropriate in the business environment in which most funds now operate.[40] Most funds are part of a large ''family of funds'' sponsored by a highly sophisticated third-party investment adviser or administrator that typically oversees assets well in excess of $50 million.[41] The adviser or administrator generally uses the same administrative, management, and compliance systems to oversee all of the funds in the complex. The fees imposed on the fund by the adviser or administrator (and the fund's resulting expense ratio) typically reflect economies of scale that the adviser or administrator achieves from managing other funds. Treating a new fund with less than $50 million of net assets as a small entity seems anomalous if the fund's adviser or administrator oversees other funds holding billions of dollars.[42]

The Commission, therefore, is proposing to amend Rule 0–10 to treat a fund as a small entity only if it and other funds in its related group have net assets of $50 million or less in the aggregate.[43] The proposed amendments would define a group of related investment companies generally to include two or more management funds that hold themselves out to investors as related companies for purposes of investment and investor services, and share either a common investment adviser (or affiliated advisers) or a common administrator.[44] In the case of unit investment trusts (''UITs''), a related group would mean two or more trusts that have a common sponsor.[45]

The proposed amendments would apply a special rule to insurance company separate accounts.[46] Because state law generally treats separate account assets as the property of the sponsoring insurance company, the rule would aggregate separate account assets with the assets of their sponsors, including other sponsored accounts.[47]

To standardize the determination of net assets, the proposed amendments would provide that the Commission may base its count of the net assets of any related group of funds on the net assets of each fund in the group at the end of each fund's fiscal year, as generally reported in Form N–SAR.[48]

The Commission estimates that as a result of the proposed amendments, approximately 400 funds would no longer be treated as small entities because they are affiliated with large fund families. Commission data suggests that approximately 800 of an estimated 3700 total active registered investment companies may be considered small entities under current Rule 0–10. Approximately 300 of these 800 funds do not identify themselves as members of a fund family, and would therefore continue to be deemed small entities. Of the remaining 500 funds, approximately 100 appear to be affiliated with fund families that have $50 million or less in aggregate assets, and therefore would continue to be deemed small entities under the proposed amendments.

The Commission requests comment on the proposed amendments to Rule 0–10. Should the definition of a group of related funds consider relationships other than a common investment adviser or administrator? When funds (like those in a master/feeder

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[38] *See supra* note 7 and accompanying text (describing exemptions from registration for small business issuers); Exchange Act rule 15c3–1 [17 CFR 240.15c3–1] (varying capital requirements for broker-dealers based on their activities).

[39] 17 CFR 270.0–10.

[40] It is appropriate to take into account the structure of business concerns in the securities industry in determining size standards. *See* 15 CFR 121.103(a)(3) (SBA rule providing for the calculation of size standards on a consolidated basis for individuals or firms with identical or substantially identical business or economic interests or that are economically dependent); *id.* § 121.103(a)(4) (SBA rule providing for the aggregation of receipts or employees of an entity and all its domestic or foreign ''affiliates'' in calculating size standards). *See also* 1981 Proposing Release, 46 FR at 19257.

[41] Nearly half (47 percent) of all fund families manage assets exceeding $1 billion per family.

[42] In the 1981 Proposing Release, the Commission noted its belief that ''the Congress did not intend to confer the benefit of any determination that an entity is small upon the affiliates of large businesses, because only those businesses and organizations that are 'independently owned' may qualify as small entities pursuant to the definitions contained in the RFA'' (*citing* 5 U.S.C. 601(4) and 15 U.S.C. 632). 46 FR at 19257. The Commission further noted its belief that it is appropriate to preclude entities with significant economic and financial resources from obtaining potential regulatory benefits under the RFA. *Id.*

[43] Conforming amendments to Rules 157(b) [17 CFR 230.157(b)] under the Securities Act and 0–10(b) [17 CFR 240.0–10(b)] under the Exchange Act would take the same approach when those statutes address investment companies. The Commission originally selected the $50 million threshold because it believed that funds having assets of $50 million or less had significantly higher expense ratios than funds with more assets, and that funds with higher expense ratios experienced greater impact from regulatory costs. 1982 Adopting Release, 47 FR at 5220. Fifty million dollars appears to remain a significant threshold for expense ratios for fund families as well as stand-alone funds, which derive similar benefits from economies of scale at lower ratios.

[44] Proposed rule 0–10(a)(1).

[45] Proposed rule 0–10(a)(2). A UIT holds a fixed portfolio of securities generally deposited with the fund by its sponsor, and does not have an investment adviser. *See generally* section 4(2) of the Investment Company Act [15 U.S.C. 80a–4(2)].

[46] Separate accounts contain assets used to fund certain insurance and investment contracts between the sponsoring insurance company and contract owners. Each account typically is organized as a UIT, or in some cases as a management fund having a sponsor-affiliated investment adviser. *See generally* section 2(a)(37) of the Investment Company Act [15 U.S.C. 80a–2(a)(37)].

[47] Proposed rule 0–10(b). This amendment would codify the Commission's longstanding approach in addressing separate accounts' status under rule 0–10. The proposed amendments would not provide a special rule for another type of fund, face amount certificate companies, which would continue to be subject to the $50 million test on a company-by-company basis.

[48] Proposed rule 0–10(c); *see* 17 CFR 274.101; Form N–SAR, Item 74T.

arrangement[49]) share a common adviser or administrator, should they be deemed a related group even though they may not hold themselves out as related (so that a feeder fund, for example, would be deemed a small entity only if the master fund is)? Alternatively, should related group status depend only on whether funds hold themselves out as related, so that funds might be in a related group even if they didn't share a common adviser or administrator? Does the $50 million asset threshold continue to be appropriate? Should the Commission consider tests other than asset size for determining whether a fund or related group is a small entity?

B. Investment Advisers

Rule 0–7 under the Investment Advisers Act currently defines ''small business'' or ''small organization'' for purposes of the RFA to include each investment adviser (''adviser'') that either (i) manages assets (''client assets'') with a total value of $50 million or less as of the end of its most recent fiscal year, and performs no other advisory services; or (ii) performs other advisory services, manages client assets of $50 million or less if it manages client funds, and has assets related to its advisory business (''business assets'') that do not exceed $50,000.[50]

Rule 0–7 currently does not distinguish between an independent adviser and an adviser that is controlled by, or under common control with, a large firm.[51] An adviser in a control relationship with a large broker-dealer or other large financial services firm typically benefits from the financial and technical resources of the large firm. The large firm may handle much of the administrative and compliance needs of its affiliated adviser using resources not reflected in the adviser's client assets or business assets.

As noted above, the Commission believes that Congress did not intend affiliates of large businesses to receive benefits under the RFA.[52] Rule 0–10 under the Exchange Act currently excludes regulated persons from small entity status when they are affiliated with a large firm through a control relationship.[53] The Commission is proposing to amend Rule 0–7 to apply a comparable provision to investment advisers.[54] Like the current definition under Exchange Act Rule 0–10, the proposed amendments to Rule 0–7 would deem an adviser ''affiliated'' with a large firm when the adviser controls, is controlled by, or is under common control with the large firm.[55] A non-control affiliation with a large firm, or a control relationship with a firm that is itself a small entity, would not trigger the exclusion.[56]

The proposed amendments also would simplify Rule 0–7 by applying the $50,000 business asset test to all advisers, rather than solely to advisers that render services other than or in addition to managing client assets.[57] In addition to facilitating application of the rule,[58] this approach would eliminate the anomaly of treating as ''small'' an adviser that manages $49 million in client assets and has $5 million in business assets (because its only advisory service is managing money for clients), while treating as ''large'' an adviser that manages $20,000 in client assets and has $55,000 in business assets (because it renders other advisory services).

The proposed amendments appear likely to have limited impact on the total number of advisers deemed small entities. The Commission estimates that up to 17,000 of approximately 22,500 total registered investment advisers meet the current rule's definition of small entity based on reported client assets or business assets.[59] Approximately 10,000 of those ''small'' advisers report that they are affiliated with broker-dealers (some of which are themselves ''small'')—but not necessarily through a control affiliation. In many cases, the affiliated broker-dealer does not own or otherwise control the adviser's advisory business. Thus, many advisers that are broker-dealer affiliates (and most other ''small'' advisers affiliated with non-brokers or having independent status) would remain small entities under the proposed amendments.

Of the ''small'' advisers that for the first time would be subject to the $50,000 business asset test (*i.e.*, the limited group that does not render advisory services other than managing client funds of $50 million or less), only a limited percentage would likely have business assets exceeding $50,000. The number of such advisers no longer treated as ''small'' probably would not exceed 2000 (or 11 percent of the total number of ''small'' advisers under the current definition), because most advisers that simply manage client funds require only modest business assets.

The Commission requests comment on the proposed amendments to Rule 0–7. Does the proposed treatment of advisers affiliated with large firms properly focus only on control affiliations? Do the thresholds of $50 million for client assets and $50,000 for business assets continue to be appropriate? Recent federal legislation transfers to states primary responsibility for regulating ''small'' advisers—those who manage less than $25 million of client assets.[60] In light of this

[49] In such an arrangement, multiple ''feeder funds'' invest all their assets in the shares of a single ''master fund'' managed by one investment adviser, thereby reducing the costs of providing investment advice to each feeder fund. The various feeder funds typically sell their shares to different investors through different distribution channels.

[50] 17 CFR 275.0–7.

[51] Such affiliations typically involve advisory firms that are controlled by or under common control with the large firm (such as a broker-dealer-owned subsidiary that advises institutional clients).

[52] *See supra* note 42.

[53] *See* 17 CFR 240.0–10(c), (d), (f), (g), and (h) (excluding from ''small'' status a broker or dealer, clearing agency, bank municipal securities dealer, securities information processor, or transfer agent affiliated through a control relationship with any person (other than a natural person) that is not a small business or small organization).

[54] The Commission is also proposing to amend the definition of ''small business'' under the Exchange Act to include consideration of other factors in addition to control relationships in determining affiliation. *See* discussion *infra* pp. 27–31. However, the Commission does not propose to include those factors in the definition of ''small business'' under the Investment Advisers Act at this time.

[55] Proposed rule 0–7(a)(2). Also in conformity with rule 0–10, ''control'' would mean the right to vote 25 percent or more of the voting securities of another person, to receive 25 percent or more of the net profits of the other person, or otherwise to direct the person's management or policies. Proposed rule 0–7(b). Many individual advisers affiliated with large firms would continue to meet the definition of ''small business'' notwithstanding the new affiliation standard because the advisers' large firm affiliates do not have the right to vote 25 percent or more of any stock issued by the advisers, do not receive 25 percent or more of the advisers' net profits, and do not direct the management of the individual advisers' business.

[56] *See* proposed rule 0–7(a)(2) and (b).

[57] Proposed rule 0–7(a)(1). The current rule's definition of ''other advisory services'' would be eliminated because it would no longer be necessary. The $50,000 threshold for the business asset test appears to remain a meaningful divide between small advisers and others. The Commission originally selected that figure because it was approximately the median value of advisers' business assets. 1982 Adopting Release, 47 FR at 5221. The median may have changed in recent years, but that figure remains significant inasmuch as more than half of all advisers apparently do not have assets exceeding it.

[58] *See* 1981 Proposing Release, 46 FR at 19257, 19263 (two attributes desirable in size standards are capacity to differentiate the small members of an industry from other members, and the use of readily available information to derive standards).

[59] Under the recently enacted National Securities Markets Improvement Act of 1996, the Commission will soon lose responsibility for regulating an estimated 16,000 of these 17,000 ''small'' advisers. *See* Pub. L. 104–290, sec. 303, 110 Stat. 3416 (1996) (transferring from the Commission to the states the primary responsibility for regulating advisers managing less than $25 million in client assets).

[60] *See id.; See also* Report on S. 1815, The Securities Investment Promotion Act of 1996, S. Rep. No. 293, 104th Cong., 2d Sess. at 3–4 (1996) (legislation would focus SEC supervision ''on investment advisers most likely to be engaged in

legislation, is a threshold of $25 million for client assets under management more appropriate than the $50 million threshold?

C. Definitions Under the Exchange Act

1. Exchanges

In the 1981 Proposing Release, the Commission expressed its doubt that Congress intended for the RFA to apply to exchanges.[61] Nevertheless, the Commission adopted a definition of ''small business'' and ''small organization'' applicable to exchanges. The Commission's proposed amendment to this definition would retain the existing provisions of Rule 0–10 that define as ''small'' those exchanges that are exempt from the requirements of Rule 11Aa3–1 regarding the dissemination of transaction reports and last sale data with respect to transactions in securities.[62]

The Commission is proposing to add a requirement that the exchange also must not be affiliated with any person (other than a natural person) that is not a small business or small organization as defined in Rule 0–10. The proposed amendment would deem an exchange ''affiliated'' with another entity when the exchange controls, is controlled by, or is under common control with the other entity. In adopting Rule 0–10 in 1982, the Commission applied this standard to broker-dealers, clearing agencies, bank municipal securities dealers, securities information processors, and transfer agents. The 1981 Proposing Release noted that such entities were not small if they were affiliated with another entity that did not qualify as small. The Commission is proposing to conform the definition of small exchange to that of other small entities by adding this affiliation standard.[63]

2. Securities Information Processors

The Commission proposes to retain the existing criteria for determining whether a securities information processor is a ''small business'' or ''small organization'' in substantially the same form, including the requirement that to be considered small, a securities information processor service less than 100 interrogation devices or moving tickets during the preceding fiscal year.[64] As a result of changes in technology since Rule 0–10 was adopted, however, the Commission is proposing to modify the definition of ''interrogation device'' for purposes of Rule 0–10 to take into account new technologies used to disseminate securities industry information to markets and market participants through increasingly diverse methods. Technological developments regarding the amount of information available electronically, the ease and speed of retrieving such information, and the increasing interconnectivity between market participants and data vendors all support a broader reading of the term interrogation device.

Accordingly, for purposes of the small business definition, the Commission believes it is appropriate to consider whether the term interrogation device should refer to any device that may be used to read or receive electronic information, including proprietary terminals or personal computers via computer to computer interfaces, or gateway access. Also, the Commission believes that it is appropriate to consider whether this definition should include all interrogation devices that display securities information such as quotations and indications of interest in addition to devices that display last sale data or transaction reports.[65]

3. Transfer Agents and Issuers

The Commission's proposal would retain the existing criteria based on volume of transfer business and number of shareholder accounts for determining whether a transfer agent is a ''small business'' or ''small organization,'' [66] and would add the requirement that small transfer agents restrict their activities to transferring the items of small issuers as defined in Exchange Act Rule 0–10.[67] The shares of small issuers, as opposed to those of large publicly traded companies, typically are held by a small portion of the investing public and are less likely to be the subject of a substantial amount of trading activity. Thus, the activities of small transfer agents, many of which are not subject to registration under Section 17A of the Exchange Act, are not likely to have a substantial effect on the investing public or the operation of the national clearance and settlement system. In contrast, transfer agents for large companies whose shares are heavily traded are likely to have a far greater effect on securities processing, generally, and on the operation of the national clearance and settlement system.[68]

Rule 0–10(a) currently applies the definition of ''small business'' when

interstate commerce'' and focus state supervision ''on advisers whose activities are most likely to be centered in their home state''; ''legislation allows states to assume the primary role with respect to regulating advisers that are small, local businesses, managing less than $25 million in client assets, while the Commission's role is focused on larger advisers with $25 million or more in client assets under management''). The Commission estimates that limiting small advisers to those managing less than $25 million in client assets would reduce the total number of small advisers by less than 500.

[61] The term ''exchange'' is defined in Section 3(a)(1) of the Exchange Act. [15 U.S.C. 78c(a)(1).] Currently, none of the eight registered exchanges is considered a ''small business'' or ''small organization'' under Rule 0–10.

[62] 17 CFR 240.11Aa3–1. In the 1981 Proposing Release, the Commission noted that those exchanges that are exempt from the requirements of Rule 11Aa3–1 would appropriately be considered small, mentioning in particular that the Spokane Stock Exchange and the Intermountain Stock Exchange had been granted exemptions from the rule, in part, because of their low trading volume. Since 1981, both of these exchanges have withdrawn from registration. Currently, no exchanges are fully exempted from the requirements of Rule 11Aa3–1.

[63] The Commission believes that it is appropriate to consider precluding entities with significant economic and financial resources from obtaining potential regulatory benefits under the RFA. *See supra* note 42. The definitions set forth in Rule 0–10 generally incorporate the concept of affiliation and provide that a broker-dealer, clearing agency, bank municipal securities dealer, securities information processor, or transfer agent is not a small business or small organization if that entity is affiliated with any person (other than a natural person) that is not a small business or small organization as defined in Rule 0–10. Under paragraph (i) of Rule 0–10, a person is affiliated with another if that person controls, is controlled by, or is under common control with such other person. Control within this context constitutes the right to vote 25 percent or more of the voting securities of any entity, the right to receive 25 percent or more of the net profits of such entity, or the ability otherwise to direct or cause the direction of the management or policies of such entity.

[64] The term ''securities information processor'' is defined in Section 3(a)(22) of the Exchange Act. [15 U.S.C. 78c(a)(22).] Currently, neither of the two registered exclusive securities information processors is designated as a ''small business'' or ''small organization'' under Rule 0–10.

[65] Formerly, paragraph (g)(2) of Rule 0–10 referenced the definition of ''interrogation device'' set forth in Rule 11Aa3–1. This definition reflects the historical use of interrogation devices to display only transaction reports or last sale data.

[66] The term ''transfer agent'' is defined in Section 3(a)(25) of the Exchange Act. [15 U.S.C. 78c(a)(25).] It is estimated that approximately 180 registered transfer agents would be designated as ''small businesses'' or ''small organizations'' under the proposed amendments to Rule 0–10.

[67] Any transfer agent that transfers items for any issuer that has total assets of greater than $5 million would not be deemed a ''small business'' or ''small organization'' under the proposed rule. Generally, transfer agents that transfer the items of small issuers are not required to be registered pursuant to Section 17A(c)(1) of the Exchange Act and are not subject to Commission regulation. In this regard, the Commission staff estimates that only 1,500 (or 21 percent) of the approximately 7,000 entities providing transfer agent services in the United States are registered under Section 17A of the Exchange Act. These 1,500 entities provide services that are essential to the efficient functioning of the national market system for securities. Of these 1,500 registered transfer agents, approximately one-half are financial institutions regulated by the various federal bank regulatory agencies. The 5,500 unregistered entities that provide transfer agent services generally handle the transfer of small issuer securities and exempted securities, such as municipal securities.

[68] *See* Securities and Exchange Commission, Study of Unsafe and Unsound Practices of Broker-Dealers (1971), pp. 37–39.

used with reference to an ''issuer'' or ''person'' under Sections 12, 13, 14, 15(d), or 16 of the Exchange Act.[69] To clarify that transfer agents who transfer items of issuers with total assets greater than $5 million would not be considered small for purposes of the RFA, the Commission is proposing to delete language in Rule 0–10(a) that limits the definition of small business, as it refers to ''issuer'' or ''person,'' to Sections 12, 13, 14, 15(d), or 16 of the Exchange Act.[70]

4. Broker-Dealers

Rule 0–10 under the Exchange Act currently defines ''small business'' or ''small organization'' to include any broker[71] or dealer[72] that has total capital of less than $500,000 and that is not affiliated with any person (other than a natural person) that is not a small business or small organization under the rule. For purposes of defining whether a broker-dealer is a ''small business'' or ''small organization,'' the Commission is proposing to retain the existing capital standard currently set forth in Rule 0–10. The Commission, however, is proposing to expand the affiliation standard applicable to broker-dealers.

The existing affiliation test, which looks only to whether a broker-dealer controls, is controlled by, or is under common control with, an entity other than a small business or small organization, focuses primarily on relationships between broker-dealers based on voting control or the sharing of profits. The structure and operation of broker-dealer activities, however, suggest that other kinds of business relationships, such as the contractual relationship between an introducing broker and its clearing firm, can give rise to an opportunity by which a clearing firm can exercise substantial influence over the business of its introducing brokers. In order to better conform its affiliation standard to the nature of business relationships that exist between broker-dealers, the Commission proposes to expand the definition of affiliation applicable to broker-dealers under Rule 0–10 to include arrangements whereby one broker-dealer introduces transactions in securities to another.

From a functional perspective, introducing and clearing brokers act as a unit in handling a customer's account. In most respects, introducing brokers are dependent on clearing firms to clear and to execute customer trades,[73] to handle customer funds and securities, and to handle many back-office functions, including issuing confirmations of customer trades and customer account statements.[74] The respective duties and obligations of an introducing broker and its clearing firm are described in the clearing agreement executed by the parties. This agreement typically contains various requirements imposed by the clearing firm with respect to the handling of customer accounts by the clearing and introducing brokers, and the clearing firm's maintenance of customer assets.[75] In addition, as a practical matter, clearing and introducing firms have identical business interests to the extent that most introducing brokers could not be in business without the capital, technology, and back-office support provided by the clearing firm. In addition, as a legal matter, for purposes of the Securities Investor Protection Act of 1970[76] and the Commission's financial responsibility rules, a customer is the customer of the clearing firm.[77]

Under the Commission's proposal, an introducing broker that introduces transactions to a large clearing firm generally would not be considered a ''small business'' or ''small organization'' for purposes of the RFA. An exception, however, would be carved out for introducing firms that handle only investment company securities or interests or participations in insurance company separate accounts. Typically, persons or firms that limit their activities to these products are small, sometimes one-person operations that combine limited securities activities with broader tax, financial planning, and insurance services. Applying this new affiliation standard in addition to the existing total capital standard, it is estimated that approximately 12 percent of all registered broker-dealers could be characterized as the type of independently owned and operated enterprise specifically addressed under the RFA.[78]

The Commission requests comments on whether alternative approaches would be more appropriate for determining whether a broker-dealer should be designated as small under Rule 0–10. One possible approach would establish a revenue test. Other approaches would be based on a broker-dealer's annual earnings or total assets. The Commission seeks comment on these approaches and requests that commenters specifically address what revenue, earnings, or total asset levels may be appropriate for distinguishing small broker-dealers, and whether

[69] 17 CFR 240.0–10(a).

[70] 15 U.S.C. 78*l*, 78m, 78n, 78o(d), and 78p. The proposed change would also clarify that a transfer agent, or any other regulated entity under the Exchange Act (broker-dealer, exchange, clearing agency, securities information processor, or bank municipal securities dealer) would not be considered small under Rule 0–10 if the entity is affiliated with an issuer that does not qualify as ''small'' under Rule 0–10. *See* 17 CFR 240.0–10. For example, a broker-dealer that is owned or controlled by a large public company with greater than $5 million in assets would not be considered small under Rule 0–10. While the Commission does not collect data that would indicate how many broker-dealers or other regulated entities may be affected by this proposed amendment, it believes such amendment is consistent with the intent of the RFA that only business and organizations that are ''independently owned'' may qualify as small entities. *See supra* note 42.

[71] The term ''broker'' is defined in Section 3(a)(4) of the Exchange Act. [15 U.S.C. 78c(a)(4).]

[72] The term ''dealer'' is defined in Section 3(a)(5) of the Exchange Act. [15 U.S.C. 78c(a)(5).]

[73] Even when introducing brokers execute their own trades, they must provide the name of their clearing broker in order that the trade may be settled and cleared.

[74] Increasingly, the back-office functions of introducing and clearing firms are linked electronically, which allows introducing brokers to transmit trades directly to the back-office systems maintained by the clearing broker using either a personal computer and modem or a terminal provided for this purpose by the clearing broker. These electronic linkages facilitate communication between introducing and clearing firms, and allow introducing firms to monitor trade execution and settlement, but control over the processing of securities trades remains with the clearing firm.

[75] For example, clearing agreements generally give clearing brokers approval over margin customers and subject margin accounts to the clearing firm's standards. Clearing brokers also may set general creditworthiness standards for the introducing broker's customers to ensure customer performance. Similarly, clearing brokers can reject customer trades if they determine a customer is unable to fully complete the trade entered through the introducing broker. New York Stock Exchange Rule 382 specifically requires clearing agreements to identify and allocate the respective functions of the introducing and clearing firms in seven areas: the opening, approving and monitoring of accounts; extensions of credit; the maintenance of books and records; the receipt and delivery of funds and securities; the safeguarding of funds and securities; confirmations and statements; and the acceptance of orders and executions of transactions. Although the customer places its order directly with the introducing firm, the Commission considers the account to be an account of the clearing firm, which has primary legal responsibility with respect to the handling of customer funds and securities, and for sending account statements to the customer. Thus, both introducing and clearing firms have a shared responsibility for ensuring that a customer's account is handled properly.

[76] 15 U.S.C. 78aaa *et seq.*

[77] Exchange Act Release No. 31511, 57 FR 56973 (Dec. 2, 1992).

[78] *See supra* note 18 (RFA definitions of ''small business''). *See also* Report to Accompany H.R. 4660, H.R. Rep. No. 519, 96th Cong., 1st Sess., 19 (1980) (suggesting that the definition of ''small businesses'' was intended to encompass businesses that are independently owned and operated and not dominant in their field of operation). Consistent with the RFA definitions of small business and small organization, SBA regulations that address affiliation consider whether individuals or firms have identical or substantially identical business interests, as in the case of firms that are economically dependent through contractual or other relationships. 13 CFR 121.103(a).

revenue, earnings, or total asset levels should be averaged over a period of years in order to account for annual fluctuations. Commenters are asked to discuss how any proposed approach relates to the SBA size standards.

5. Request for Comment

The Commission is soliciting comment on each of the proposed amendments to Rule 0–10 and whether commenters believe the proposed amendments sufficiently identify entities regulated under the Exchange Act that should qualify as either a ''small business'' or a ''small organization'' under Rule 0–10.

III. Effects on Competition and Regulatory Flexibility Considerations

Section 23(a)(2) of the Exchange Act [79] requires the Commission, in adopting rules under the Exchange Act, to consider the anticompetitive effects of such rules, if any, and to balance any anticompetitive impact against the regulatory benefits gained in terms of furthering the purposes of the Exchange Act. The Commission is of the preliminary view that the proposed amendments to Rule 0–10 would not have any effect on the regulation of entities under the Exchange Act, or impose any burden on competition among such entities.

The Commission has conferred with the SBA and believes that no regulatory flexibility analysis is required for the proposed amendments. The definitions of the terms ''small business'' and ''small organization'' and the proposed amendments do not impose any substantive requirements on small businesses. Instead the definitions are interpretations of terms used to identify those entities that the Commission will study for RFA purposes when proposing and adopting rules.[80]

[79] 15 U.S.C. 78w(a)(2).

[80] An initial regulatory flexibility analysis is required whenever an agency is required by section 553 of the Administrative Procedure Act or any other law to publish general notice of proposed rulemaking for any proposed rule. The RFA does not state that agencies that establish definitions of ''small business'' or ''small organization'' do so pursuant to rulemaking. *See* 5 U.S.C. §§ 601(3), 601(4); *see also* Definitions of Small Entity and Significant Economic Impact for Making Determinations Required by the Regulatory Flexibility Act of 1980, 51 FR 45831 (Dec. 22, 1986) (Federal Aviation Administration, Department of Transportation); NRC Size Standard for Making Determinations Required by the Regulatory Flexibility Act of 1980, 50 FR 20913 (May 21, 1985) (Nuclear Regulatory Commission invitation for public comment on proposed definition of small entities); Proposed Establishment of Definitions of ''Small Entities'' for Purposes of the Regulatory Flexibility Act, 46 Fed. Reg. 23940 (Apr. 29, 1981) (Commodity Futures Trading Commission); 1982 Adopting Release, 47 FR at 5216 (noting that the rules providing the definitions of ''small business'' for entities regulated under the securities laws also provide, as permitted by the RFA, that the Commission may, in particular instances, define a particular entity in a manner different from that set forth in the rules).

IV. Statutory Authority

The Commission is proposing to amend Rule 157 [17 CFR 230.157], Rule 0–10 [17 CFR 240.0–10], Rule 0–10 [17 CFR 270.0–10], and Rule 0–7 [17 CFR 275.0–7] pursuant to chapter 6 of title 5 of the United States Code (particularly section 601 thereof [5 U.S.C. 601]), and pursuant to the Securities Act of 1933 [15 U.S.C. 77a *et seq.*] (particularly section 19 thereof [15 U.S.C. 77s]), the Securities Exchange Act of 1934 [15 U.S.C. 78a *et seq.*] (particularly section 23 thereof [15 U.S.C. 78w]), the Investment Company Act of 1940 [15 U.S.C. 80a-1 *et seq.*] (particularly section 38 thereof [15 U.S.C. 80a-37]), and the Investment Advisers Act of 1940 [15 U.S.C. 80b-1 *et seq.*] (particularly section 211 thereof [15 U.S.C. 80b-11]).

Text of Proposed Rule Amendments

List of Subjects

17 CFR Parts 230 and 270

Investment companies, Securities.

17 CFR Part 240

Brokers, Reporting and recordkeeping requirements, Securities.

17 CFR Part 275

Investment advisers, Reporting and recordkeeping requirements, Securities.

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

PART 230—GENERAL RULES AND REGULATIONS, SECURITIES ACT OF 1933

1. The authority citation for Part 230 continues to read, in part, as follows:

Authority: 15 U.S.C. 77b, 77f, 77g, 77h, 77j, 77s, 77sss, 78c, 78d, 78*l*, 78m, 78n, 78o, 78w, 78*ll*(d), 78t, 80a-8, 80a-29, 80a-30, and 80a-37, unless otherwise noted.

* * * * *

2. Section 230.157 is amended by revising paragraph (b) to read as follows:

§ 230.157 Small entities for purposes of the Regulatory Flexibility Act.

* * * * *

(b) When used with reference to an investment company that is an issuer for purposes of the Act, have the meaning ascribed to those terms by § 270.0–10 of this chapter.

PART 240—GENERAL RULES AND REGULATIONS, SECURITIES EXCHANGE ACT OF 1934

3. The authority citation for Part 240 continues to read in part as follows:

Authority: 15 U.S.C. 77c, 77d, 77g, 77j, 77s, 77eee, 77*ggg*, 77nnn, 77sss, 77ttt, 78c, 78d, 78f, 78i, 78j, 78k, 78k-1, 78*l*, 78m, 78n, 78o, 78p, 78q, 78s, 78w, 78x, 78*ll*(d), 79q, 79t, 80a-20, 80a-23, 80a-29, 80a-37, 80b-3, 80b-4 and 80b-11, unless otherwise noted.

* * * * *

4. Section 240.0–10 is amended to revise the section heading and paragraphs (a), (b), (e), (g)(2), (g)(3), and (i); redesignate paragraphs (h)(2) and (h)(3) as paragraphs (h)(3) and (h)(4), respectively; and add paragraphs (h)(2), (j) and (k) to read as follows:

§ 240.0–10 Small entities under the Securities Exchange Act for purposes of the Regulatory Flexibility Act.

* * * * *

(a) When used with reference to an ''issuer'' or a ''person,'' other than an investment company, mean an ''issuer'' or ''person'' that, on the last day of its most recent fiscal year, had total assets of $5,000,000 or less;

(b) When used with reference to an ''issuer'' or ''person'' that is an investment company, have the meaning ascribed to those terms by § 270.0–10 of this chapter;

* * * * *

(e) When used with reference to an exchange, mean any exchange that:

(1) Has been exempted from the reporting requirements of § 240.11Aa3–1; and

(2) Is not affiliated with any person (other than a natural person) that is not a small business or small organization as defined in this section;

* * * * *

(g) * * *

(2) Provided service to fewer than 100 interrogation devices or moving tickers at all times during the preceding fiscal year (or in the time that it has been in business, if shorter); and

(3) Is not affiliated with any person (other than a natural person) that is not a small business or small organization under this section;

(h) * * *

(2) Transferred items only of issuers that would be deemed ''small businesses'' or ''small organizations'' as defined in this section;

* * * * *

(i) For purposes of paragraph (c) of this section, a broker or dealer is affiliated with another person if:

(1) Such broker or dealer controls, is controlled by, or is under common control with such other person; a person

shall be deemed to control another person if that person has the right to vote 25% or more of the voting securities of such other person or is entitled to receive 25% or more of the net profits of such other person or is otherwise able to direct or cause the direction of the management or policies of such other person; or

(2) Such broker or dealer introduces transactions in securities, other than registered investment company securities or interests or participations in insurance company separate accounts, to such other person, or introduces accounts of customers or other brokers or dealers, other than accounts that hold only registered investment company securities or interests or participations in insurance company separate accounts, to such other person that carries such accounts on a fully disclosed basis.

(j) For purposes of paragraphs (d) through (h) of this section, a person is affiliated with another person if that person controls, is controlled by, or is under common control with such other person; a person shall be deemed to control another person if that person has the right to vote 25% or more of the voting securities of such other person or is entitled to receive 25% or more of the net profits of such other person or is otherwise able to direct or cause the direction of the management or policies of such other person.

(k) For purposes of paragraph (g) of this section, ''interrogation device'' shall refer to any device that may be used to read or receive securities information, including quotations, indications of interest, last sale data and transaction reports, and shall include proprietary terminals or personal computers that receive securities information via computer to computer interfaces or gateway access.

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

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

Authority: 15 U.S.C. 80a–1 *et seq.*, 80a–37, 80a–38, unless otherwise noted;

* * * * *

6. Section 270.0–10 is revised to read as follows:

§ 270.0–10 Small entities under the Investment Company Act for purposes of the Regulatory Flexibility Act.

(a) *General.* For purposes of Commission rulemaking in accordance with the provisions of Chapter Six of the Administrative Procedure Act (5 U.S.C. 601 *et seq.*) and unless otherwise defined for purposes of a particular rulemaking, the term *small business* or *small organization* for purposes of the Act shall mean an investment company that, together with other investment companies in the same group of related investment companies, has net assets of $50 million or less as of the end of its most recent fiscal year. For purposes of this section:

(1) In the case of a management company, the term *group of related investment companies* shall mean two or more management companies (including series thereof) that:

(i) Hold themselves out to investors as related companies for purposes of investment and investor services; and

(ii) Either:

(A) Have a common investment adviser or have investment advisers that are affiliated persons of each other; or

(B) Have a common administrator; and

(2) In the case of a unit investment trust, the term *group of related investment companies* shall mean two or more unit investment trusts (including series thereof) that have a common sponsor.

(b) *Special rule for insurance company separate accounts.* In determining whether an insurance company separate account is a *small business* or *small entity* pursuant to paragraph (a) of this section, the assets of the separate account shall be cumulated with the assets of the general account and all other separate accounts of the insurance company.

(c) *Determination of net assets.* The Commission may calculate its determination of the net assets of a group of related investment companies based on the net assets of each investment company in the group as of the end of such company's fiscal year.

PART 275—RULES AND REGULATIONS, INVESTMENT ADVISERS ACT OF 1940

7. The authority citation for Part 275 continues to read, in part, as follows:

Authority: 15 U.S.C. 80b–1 *et seq.*, 80b–11, unless otherwise noted.

* * * * *

8. Section 275.0–7 is amended by revising the section heading and paragraphs (a)(1), (a)(2) and (b) to read as follows:

§ 275.0–7 Small entities under the Investment Advisers Act for purposes of the Regulatory Flexibility Act.

(a) * * *

(1) Manages assets with a total value of $50 million or less, in discretionary or non-discretionary accounts, as of the end of its most recent fiscal year, *provided that* the adviser's own assets related to its advisory business do not exceed in value $50,000 as of the end of its most recent fiscal year; and

(2) Is not affiliated with any person (other than a natural person) that is not a small business or small organization as defined in this section, § 240.0–10 or § 270.0–10 of this chapter.

(b) For purposes of this section, a person is affiliated with another person if that person controls, is controlled by, or is under common control with such other person; a person shall be deemed to control another person if that person has the right to vote 25% or more of the voting securities of such other person or is entitled to receive 25% or more of the net profits of such other person or is otherwise able to direct or cause the direction of the management or policies of such other person.

Dated: January 22, 1997.

By the Commission.

Margaret H. McFarland,

Deputy Secretary.

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