

Applicability of Regulation NMS to SEC Exemption from Prohibition on Affiliated Investment Companies' Transactions: Section 17(a) of the 1940 Act and Rule 17a-7

With the recent adoption of Regulation NMS, the Securities and Exchange Commission (the "Commission") amended Rule 17a-7(b)(1) under the Investment Company Act of 1940 (the "1940 Act").¹ That amendment may cause confusion because of the use of the new term "NMS Stock" and because the definition of the term "reported security" was removed by Regulation NMS, while the term remains in Rule 17a-7(b)(1). This update explains that the changes do not affect the substantive requirements of Rule 17a-7(b)(1).

Section 17 of the 1940 Act generally prohibits various securities transactions between affiliated persons. However, Rule 17a-7 under the 1940 Act permits affiliated investment companies to engage in securities transactions with one another if certain requirements are met. To qualify for this exemption, the transaction must, among other qualifications, be "effected at the independent current market price of the security."²

Prior to August 29, 2005, the effective date of Regulation NMS,³ Rule 17a-7(b) defined "current market price" as follows (emphasis added):

- If the security is a *reported security* as that term is defined in Rule 11Aa3-1 under the Securities Exchange Act of 1934 ("Exchange Act"), the last sale price with respect to such security reported in the consolidated transaction reporting system ("consolidated system") or the average of the highest current independent bid and lowest current independent offer for such security if there are no reported transactions in the consolidated system that day
- If the security is not a *reported security*, and the principal market for such security is an exchange, then the last sale on such exchange or the average of the highest current independent bid and lowest current independent offer on such exchange if there are no reported transactions on such exchange that day
- If the security is not a *reported security* and is quoted in the NASDAQ System, then the average of the highest current

Rel. No. 34-52355 (Aug. 29, 2005). The compliance date for sub-penny quoting was extended to January 1, 2006 by Exchange Act Rel. No. 34-52196 (Aug. 2, 2005). See also SEC Commissioner Paul Atkins, Remarks before the SIA Compliance and Legal Division Fall Compliance Seminar (Nov. 9, 2005), available at http://www.sec.gov/news/speech/spch110905p_sa.htm (discussing Regulation NMS implementation).

¹ See *Dechert OnPoint: Divided SEC Adopts Regulation NMS* (Sept. 2005 / Issue 15).

² Rule 17a-7(b) under the 1940 Act.

³ See *Regulation NMS*, Exchange Act Rel. No. 34-51808 (Aug. 29, 2005) ("Adopting Release"). The compliance date for Rule 301(b)(5) was extended to September 28, 2005 by Exchange Act

independent bid and lowest current independent offer reported on Level 1 of NASDAQ

- For all other securities, the average of the highest current independent bid and lowest current independent offer determined on the basis of reasonable inquiry

As part of the adoption of Regulation NMS, the Commission also amended Rule 17a-7(b)(1) because it contained a reference to Rule 11Aa3-1, which was one of the Exchange Act rules replaced by Regulation NMS. When Regulation NMS became effective on August 29, 2005, Rule 17a-7(b)(1) was amended to read (emphasis added):

If the security is an “NMS stock” as that term is defined in Rule 600 of Regulation NMS, the last sale price with respect to such security reported in the consolidated transaction reporting system (“consolidated system”) or the average of the highest current independent bid and lowest current independent offer for such security (reported pursuant to Rule 602 of Regulation NMS) if there are no reported transactions in the consolidated system that day; or ...

Two issues may arise under Rule 17a-7(b) as amended. First, difficulty may arise in identifying which securities are covered by the term “NMS Stock.” Second, the implications of the continued use of the term “reported security” in subsections (b)(2) and (b)(3) are unclear since the reference to the definition of “reported security” was removed from (b)(1) and the term is no longer defined anywhere in the federal securities laws.

NMS Stock

An “NMS Stock” is defined as “any NMS security other than an option.”⁴ An “NMS Security” is defined as “any security or class of securities for which transaction reports are collected, processed, and made available pursuant to an effective transaction reporting plan, or an effective national market system plan for reporting transactions in listed options.”⁵

Current effective transaction reporting plans are the CTA Plan, which covers securities listed on national ex-

⁴ Regulation NMS Rule 600(b)(47).

⁵ Regulation NMS Rule 600(b)(46).

changes,⁶ and the Nasdaq OTC/UTP Plan, which covers all securities traded through Nasdaq National Market or Nasdaq Capital Market (formerly Nasdaq SmallCap Market). The term “NMS Stock” therefore includes all securities, other than options, that are either exchange-listed on a participating exchange or traded on the Nasdaq National Market or Nasdaq Capital Market.⁷

“Reported security” included those securities for which transaction reports were made available pursuant to an effective transaction reporting plan, but did not include options, for which reports were made available pursuant to an effective national market system plan.⁸

According to the Commission, the change in terminology from “reported security” to “NMS Stock” was implemented for the sake of clarity and consistency, and was not meant to have a substantive effect.⁹ Both terms cover securities, other than options, for which transaction reports are made available pursuant to an effective transaction reporting plan. The term “NMS Stock” is

⁶ CTA participants include the American Stock Exchange, Boston Stock Exchange, Chicago Board Options Exchange, Chicago Stock Exchange, National Association of Securities Dealers, National Stock Exchange, New York Stock Exchange, ArcaEx/Pacific Exchange, and Philadelphia Stock Exchange.

⁷ For a directory of Nasdaq National Market securities, see <http://www.nasdaq.com/asp/symbols.asp?exchange=NNM>. For a directory of Nasdaq Capital Market securities, see <http://www.nasdaq.com/asp/symbols.asp?exchange=SCM>.

⁸ The definition of “reported security” in former Exchange Act Rule 11Aa3-1(a)(4) is “any security or class of securities for which transaction reports are collected, processed and made available pursuant to an effective transaction reporting plan.” An “effective transaction reporting plan” is “any transaction reporting plan approved by the Commission” pursuant to former Exchange Act Rule 11Aa3-1. Unlike the CTA Plan and the Nasdaq UTP Plan, which are transaction reporting plans approved pursuant to Exchange Act Rules 11Aa3-1 and 11Aa3-2 (redesignated as Regulation NMS Rules 601 and 608), the Commission approved the Plan for Reporting of Consolidated Options Last Sale Reports and Quotation Information (“OPRA Plan”) pursuant to Exchange Act Rule 11Aa3-2 (redesignated as Regulation NMS Rule 608). See Exchange Act Release No. 17638 (Mar. 18, 1981). The OPRA Plan is therefore an “effective national market system plan” but not an “effective transaction reporting plan.” Because the OPRA Plan is not an effective transaction reporting plan, listed options covered by the OPRA Plan are not “securities for which transaction reports are collected, processed, and made available pursuant to an effective transaction reporting plan.” The term “reported security” thus excluded options.

⁹ Adopting Release, *supra* note 1, at 303-305.

therefore essentially synonymous with “reported security.”

Reported Security

In the proposing release for Regulation NMS, the Commission expressed its intention to “eliminate the term ‘reported security’ from the NMS rules and replace it with the term ‘NMS security’ or ‘NMS stock,’ depending on the scope of the particular rule.”¹⁰ Given the Commission’s decision to update terminology related to Regulation NMS, confusion may arise from the continued use of the term “reported security” in subsections (b)(2) and (b)(3) of Rule 17a-7 under the 1940 Act.

Because the terms “reported security” and “NMS Stock” are meant to be synonymous, any security that qualifies as an “NMS Stock” should be considered a “reportable

¹⁰ *Id.*, at 292.

security” for purposes of subsections (b)(2) and (b)(3) of Rule 17a-7. Dechert attorneys have confirmed in informal conversations with individual members of the staff of the Division of Market Regulation that continued use of the term “reported security” in subsections (b)(2) and (b)(3) was inadvertent. This conclusion is consistent with the Commission’s statement that “[T]he definitional changes [in Regulation NMS] do not affect the substantive requirements of the existing NMS rules.”¹¹

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This update was authored by Alan Rosenblat (+1 202 261 3332; alan.rosenblat@dechert.com), Stuart Kaswell (+1 202 261 3314; stuart.kaswell@dechert.com), Jennifer O. Epstein (+1 202 261 3446; jennifer.epstein@dechert.com), and Samuel K. Goldstein (+1 215 994 2269; samuel.goldstein@dechert.com).

¹¹ *Id.*, at 283.

Additional practice group contacts

For further information, please contact the authors, one of the attorneys listed, or any Dechert LLP attorney with whom you are in regular contact. Visit us at www.dechert.com/financialservices.

Sander M. Bieber
Washington
+1 202 261 3308
sander.bieber@dechert.com

Joseph R. Fleming
Boston
+1 617 728 7161
joseph.fleming@dechert.com

Stuart J. Kaswell
Washington
+1 202 261 3314
stuart.kaswell@dechert.com

Timothy M. Clark
New York
+1 212 698 3652
timothy.clark@dechert.com

Brendan C. Fox
Washington
+1 202 261 3381
brendan.fox@dechert.com

George J. Mazin
New York
+1 212 698 3570
george.mazin@dechert.com

Douglas P. Dick
Newport Beach
+1 949 442 6060
douglas.dick@dechert.com

David J. Harris
Washington
+1 202 261 3385
david.harris@dechert.com

Jack W. Murphy
Washington
+1 202 261 3303
jack.murphy@dechert.com

Ruth S. Epstein
Washington
+1 202 261 3322
ruth.epstein@dechert.com

Robert W. Helm
Washington
+1 202 261 3356
robert.helm@dechert.com

John V. O’Hanlon
Boston
+1 617 728 7111
john.ohanlon@dechert.com

Susan C. Ervin
Washington
+1 202 261 3325
susan.ervin@dechert.com

Jane A. Kanter
Washington
+1 202 261 3302
jane.kanter@dechert.com

Jeffrey S. Poretz
Washington
+1 202 261 3358
jeffrey.poretz@dechert.com

Jon S. Rand
New York
+1 212 698 3634
jon.rand@dechert.com

Frederick H. Sherley
Charlotte
+1 704 339 3100
frederick.sherley@dechert.com

David A. Vaughan
Washington
+1 202 261 3355
david.vaughan@dechert.com

Keith T. Robinson
Washington
+1 202 261 3386
keith.robinson@dechert.com

Patrick W. D. Turley
Washington
+1 202 261 3364
patrick.turley@dechert.com

Alan Rosenblat
Washington
+1 202 261 3332
alan.rosenblat@dechert.com

Brian S. Vargo
Philadelphia
+1 215 994 2880
brian.vargo@dechert.com

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