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SEC Regulation of Investment Company Investments in Securities Related Businesses Under the Investment Company Act of 1940

Lawrence P. Stadulis and Timothy W. Levin*

Section 12(d)(3) of the Investment Company Act of 1940 (the "Investment Company Act") prohibits registered investment companies from acquiring securities or other interests in issuers engaged in securities related businesses, such as brokers, dealers, underwriters or investment advisers. The legislative history of the Investment Company Act is virtually silent concerning the intended scope and purpose of section 12(d)(3). Despite this fact, the Securities and Exchange Commission (the "Commission" or "SEC") and its staff historically have interpreted section 12(d)(3) to be "one of several provisions, which taken together, were designed to prevent investment companies from being organized, operated, managed, or their portfolio securities selected in the interests of brokers, dealers, underwriters, and investment advisers." Consistent with this philosophy, the

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2 Section 12(d)(3)'s prohibitions do not apply to pooled investment vehicles excepted from the definition of "investment company" under section 3(c) of the Investment Company Act of 1940 ("Investment Company Act") or exempted from registration under section 6 of the Act. 15 U.S.C. §§ 80a-3(c) and 80a-(6) (1999). For example, section 12(d)(3) does not apply to private investment companies excluded from the definition of investment company under sections 3(c)(1) or 3(c)(7).

Commission and its staff have sought to apply section 12(d)(3) to a broad range of investments by investment companies in securities related businesses, including certain businesses that fall outside of the section's literal terms.

At the same time, the Commission and its staff periodically have reexamined "the purposes underlying section 12(d)(3) and changes in the securities industry since 1940" and determined to exempt certain acquisitions believed not to raise the same types of concerns that the section was designed to address. The most notable exemption is contained in Investment Company Act rule 12d3-1, which the Commission originally adopted in 1964 as rule 12d-16 and substantively amended in 1984 and again in 1993. This article traces the legislative and administrative history of section 12(d)(3) and rule 12d3-1. The first section provides an overview of section 12(d)(3). The second section reviews the sparse legislative history of the section, as well as some of the more general concerns pertaining to investment company relationships and transactions with securities related businesses that prompted Congress to enact the Investment Company Act. The second section also examines various rationales that the Commission and its staff have advanced since 1940 to explain the policy and purpose underlying section 12(d)(3).

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The third section analyzes the specific elements of section 12(d)(3), as well as Commission and staff interpretations under the section. The fourth section examines the administrative history of rule 12d3-1, the terms of the rule, Commission and staff interpretations thereunder, and recent SEC exemptive orders. The fifth section briefly reviews SEC enforcement proceedings under section 12(d)(3) and rule 12d3-1.

The final section of the article concludes that, for the most part, the Commission and its staff have interpreted and applied section 12(d)(3) in accordance with the first, and perhaps the most fundamental, canon of statutory construction — “when language is clear and unambiguous it must be held to mean what it plainly expresses.” The section, however, also addresses one instance in which the literal terms of the section have been disregarded in furtherance of what the Commission and its staff perceive to be the policy and purpose underlying section 12(d)(3). While this departure from the plain meaning rule appears at first blush to be somewhat defensible given the Commission’s unique investor protection mission, a careful analysis of the Investment Company Act legislative history indicates that it contravenes another important rule of statutory construction — that the literal terms of a statute should be disregarded only “if the plain meaning of the words of the statute is at variance with the policy of the statute or if there is a clearly expressed legislative intention contrary to the language of the statute.”

9 2A NORMAN J. SINGER, SUTHERLAND STATUTORY CONSTRUCTION § 46.01 (5th ed. 1992) (hereinafter SUTHERLAND).
10 Id.
I. INTRODUCTION

Section 12(d)(3) prohibits registered investment companies and companies controlled by such registered investment companies from “purchasing or otherwise acquiring any security issued by or any other interest in the business of any person who is a broker, a dealer, is engaged in the business of underwriting, or is either an investment adviser of an investment company or an investment adviser registered under [the Investment Advisers Act of 1940]. . .”\(^1\) Section 12(d)(3) provides that these prohibitions do not apply to the acquisition of securities of a corporation all of the outstanding voting securities of which (other than short-term paper, bank loans and directors’ qualifying shares) are, or after acquisition will be, owned by one or more registered investment companies, if such corporation is primarily engaged in the business of underwriting and distributing securities issued by other persons, selling securities to customers, or any one or more of such or related activities and if the gross income of such person normally is derived principally from such business or related activities.

The effect of the exception in section 12(d)(3) is to permit investment companies to acquire securities of a wholly owned underwriting subsidiary. This is consistent with other provisions of the Investment Company Act which, with one limited exception, do not prohibit investment companies from directly engaging in the securities underwriting business.\(^2\) Thus, the exception to section

\(^1\) The term “control” is defined in Investment Company Act section 2(a)(9) as the “power to exercise a controlling influence over the management or policies of a company . . .” For purposes of this definition, a person is presumed to control another person if it “owns beneficially, either directly or through one or more controlled companies, more than 25 per centum of the voting securities” of such other person. 15 U.S.C. § 80a-2(a)(9) (1999).

\(^2\) See, e.g., Investment Company Act section 10(f) (prohibiting registered investment company from purchasing security during existence of underwriting or selling syndicate if certain enumerated persons or their affiliates serve as principal underwriter, except where investment company, itself, is principal underwriter of securities). 15 U.S.C. § 80a-10(f)(1999).
12(d)(3) merely recognizes that "if investment companies were permitted themselves to engage in the business of underwriting, there was no reason why, and possibly it was more desirable that, they should conduct this business through an underwriting subsidiary."\textsuperscript{13}

II. LEGISLATIVE HISTORY

A. SECTION 12(d)(3) LEGISLATIVE HISTORY

There is very little direct commentary in the legislative history of the Investment Company Act concerning the intended scope and purpose of section 12(d)(3). The original Senate version of the bill, which ultimately led to the enactment of the Act, provided in section 12(c)(2) that

\textit{It shall be unlawful for any registered investment company to purchase or otherwise acquire any security issued by, or any other interest in the business of . . . any person who is a broker, dealer, underwriter, manager, or investment adviser, unless (A) such person is a corporation all of the outstanding securities of which (other than short-term paper) are, or after such acquisition will be, owned by such investment company;}

\textsuperscript{13} Alfred Jaretzki, Jr., \textit{The Investment Company Act of 1940}, 26 Wash. U. L.Q., 303, 326 (1940).

The one limited exception is contained in Investment Company Act section 12(c), which prohibits a "diversified" investment company from making any commitment as underwriter, "if immediately thereafter the amount of its outstanding underwriting commitments, plus the value of its investments in securities of issuers (other than investment companies) of which it owns more than 10 per centum of the outstanding voting securities, exceeds 25 per centum of the value of its total assets." \texttt{15 U.S.C. \S 80a-12(c) (1999).} The term "diversified company" is defined in Investment Company Act section 5(b)(1) as a management investment company meeting the following requirements:

- At least 75 per centum of the value of its total assets is represented by cash and cash items (including receivables), Government securities, securities of other investment companies, and other securities for the purpose of this calculation limited in respect of any one issuer to an amount not greater in value than 5 per centum of the value of the total assets of such management company and to not more than 10 per centum of the outstanding voting securities of such issuer.

\texttt{15 U.S.C. \S 80a-5(b)(1) (1999).}
and (B) the business of such person is confined to activities in which such registered company itself may lawfully engage.\textsuperscript{14}

During the Senate hearings, David Schenker, the principal draftsman of the bill stated that

Section 12(c)(2) merely states that an investment company cannot buy an interest in a brokerage firm, a distributing company, or an investment banking house. It goes further and says that if it is engaged in the underwriting business itself — if engaged in that business through a wholly owned subsidiary — it is permissible to do so.

You can see the reason for that. They may not want to subject all the assets of the investment trust to the risks of the underwriting business. So we see no difficulty if they avail themselves of the corporate fiction and limit their liabilities to the amount of money they want to invest. So we say, if you want to go into the underwriting business and want to do it through the wholly owned subsidiary, there is no difficulty with that situation.\textsuperscript{15}

Aside from this one statement, both the Senate and House hearings on the proposed legislation are silent concerning the purpose of section 12(d)(3). The Senate report accompanying a later version of the bill, however, states that

Although investment companies are in general prohibited from acquiring securities of persons engaged in the brokerage business or in the business of underwriting and dealing in securities, provision is made to permit investment companies, either alone or jointly with other investment companies, to purchase stock of a company engaged primarily in the business of underwriting and distributing securities and to acquire


\textsuperscript{15} Id. at 243.
stock of a company formed to engage in the business of furnishing new capital to industry, financing promotional enterprises and similar activities. It is hoped that investment companies will soon jointly form such a company.\textsuperscript{16}

This statement reflects the fact that the Commission and the investment company industry agreed to add a new provision to section 12 in a later version of the bill "which may encourage the opening up of the capital markets."\textsuperscript{17} This provision, which ultimately became section 12(e) of the Investment Company Act, "states that a group of investment companies can buy an interest in a company to be formed where the primary business of this company shall be to promote industry, finance industry, underwrite and make loans."\textsuperscript{18} There do not appear to be any other meaningful statements in the legislative history directly addressing section 12(d)(3).\textsuperscript{19}

\textbf{B. GENERAL LEGISLATIVE HISTORY OF THE INVESTMENT COMPANY ACT}

Despite the dearth of legislative history directly relating to section 12(d)(3), the legislative history of the Investment Company Act in general contains numerous references to concerns uniquely associated with investment company relationships and transactions with securities related businesses. For example, one of the principal reasons Congress enacted the Investment Company Act was that "[b]rokers, security dealers, investment bankers, and commercial banks are in a position to dominate ... investment companies; and thus, when they are


\textsuperscript{17} Id. See also Hearings Before a Subcomm. of a Comm. on Interstate and Foreign Commerce, 76th Cong. 3d Sess. 113-114 (1940).

\textsuperscript{18} Id.

\textsuperscript{19} The report accompanying the House version of the bill merely states that this provision "prohibits investment companies from acquiring securities of persons engaged in the brokerage business or in the business of underwriting or dealing in securities. ..." H.R. Rep. No. 76-2639, at 16 (1940).
unscrupulous, to advance their own pecuniary interests at the expense of the investment companies and their security holders." In fact, section 1 of the Act, which contains the findings and declaration of policy of Congress, expressly states that the national public interest and the interests of investors are adversely affected "when investment companies are organized, operated, managed, or their portfolio securities are selected . . . in the interest of underwriters, brokers, or dealers. . . ." 21

The specific types of concerns that Congress associated with investment banking businesses are principally set forth in the Commission study of the investment company industry that ultimately led to the introduction of the Senate bill into Congress (the "Investment Trust Study"). In general, Congress was concerned that an investment banker might be more concerned with the receipt of sales loads on the sale of investment company shares and commissions on the purchase and sale of portfolio securities, as well as the opportunity to dump illiquid securities in the investment company, than in providing a service to the public. 22

20 Senate Report at 7, supra note 16.
22 The Investment Trusts Study expressed the following concerns about the motivations of the investment banking community in establishing investment companies.

The underwriting and distribution of the securities issued at organization, and from time to time thereafter, by an investment company, constituted a source of business to a sponsor who was an investment banker or securities distributor. Sponsors also were able to utilize investment companies as a means of selling indirectly securities which could not be directly sold on the market, by placing non-marketable security issues in the portfolios of investment companies and then making an offering to the public of the more salable shares of the latter. The distribution activities of security dealers were particularly augmented through the continuous sales campaigns usual in the operation of fixed and semifixed trusts and "open-end" investment companies.

A steady flow of brokerage commissions was implicit in the organization and operation of investment companies, since their portfolio activities required, almost invariably, the continual buying and selling of securities. . . . For the investment banker sponsor, the purchasing power of large pools of liquid funds accumulated by the
The concerns that Congress associated with commercial banking businesses principally stemmed from arrangements where such businesses organized and operated investment companies as securities affiliates. The sphere of activity of these securities affiliates embraced the following: "wholesaling and retailing of security issues; serving as holding and finance companies in carrying blocks of securities, for control or otherwise, which the bank could not or would not list among its own investments; assuming such loans and investments of the parent bank which might prove doubtful and nonliquid; supporting the market in the bank's own stock; and finally acting as investment companies in buying and selling securities for investment or speculative purposes."  

C. SEC ADMINISTRATIVE HISTORY

Since 1940, the Commission and its staff have advanced a number of explanations of the underlying policy and purpose of section 12(d)(3). Some of these rationales are clearly supported by the literal terms of section 12(d)(3), while others seem to be based more on the policy and purposes underlying the Investment Company Act as a whole. Each of these rationales is discussed below.

Investment company was valuable not only to acquire securities underwritten by such sponsor and thereby to increase the latter's underwriting capacity, but also, at times, to take over blocks of securities in which the capital of such sponsor might have become too heavily involved. Furthermore, an opportunity to achieve new banking connections was constantly presented through the sponsor's access to and influence on the companies represented in the investment company portfolio.

There were many less tangible but none the less valuable advantages and benefits to persons engaged in the securities business inherent in the management of large pools of liquid funds and the control of blocks of securities, such as opportunities for reciprocal business, patronage, power to influence or to participate in the management of the affairs of portfolio corporations, and the prestige attendant upon the successful management of the investment company.


20 Id. at 94.
1. Engaging in Diverse Financial Activities

The Commission's first public statement concerning the purpose of section 12(d)(3) was in a 1946 notice of an application requesting an order that a registered investment company had ceased to be an investment company within the meaning of the Investment Company Act.\(^{24}\) The SEC stated in that notice that section 12(d)(3) "obviously [is] intended to prevent operating investment companies from engaging in diverse financial activities in conjunction with persons other than investment companies. . . ."\(^{25}\) This rationale was certainly consistent with the terms of the section.

2. Entrepreneurial Risk

The Commission's next public statement concerning the intended scope and purpose of section 12(d)(3) appeared approximately 38 years later in the release proposing Investment Company Act rule 12d3-1.\(^{26}\) The Commission stated in this release that the purpose of section 12(d)(3) was "to prevent investment companies from exposing their assets to the entrepreneurial risks of securities related businesses." According to the release, the problem was that in 1940 most securities related businesses were organized as private partnerships. To protect investment company shareholders from bearing the risks associated with general partnership interests, Congress restricted investment in securities related businesses.\(^{27}\)

There is nothing in the section 12(d)(3) legislative history, the general legislative history of the Investment

\(^{24}\) In the Matter of Pacific Coast Mortgage Co., 22 SEC 829, 832 (1946).
\(^{25}\) Id. at 832.
\(^{27}\) This argument appears to be based upon a statement contained in a 1977 SEC interpretive release addressing entry by investment companies into repurchase agreements with broker-dealers. See Securities Trading Practices of Registered Investment Companies: General Statement of Policy, Investment Company Act Release No. 10,666 (Apr. 18, 1979), 44 Fed. Reg. 25,128. See also Investment Trust Study, Section IV.C., supra note 22.
Company Act or the preamble to the Act to support the Commission’s position. In fact, as noted above, except for certain restrictions imposed on diversified investment companies, the Investment Company Act has permitted all types of investment companies since its inception to engage directly in the securities underwriting business and, therefore, directly to expose all or a substantial portion of their assets to the entrepreneurial risks associated with such businesses. Therefore, it seems unlikely that Congress principally was concerned with the more indirect exposure of such assets to entrepreneurial risks through investments in partnerships.

The lack of support in the record for this argument, however, has not prevented the Commission or its staff from tendering it on numerous subsequent occasions.  

3. Reciprocal Practices

In the release proposing rule 12d3-1, the Commission put forth another rationale for the enactment of section 12(d)(3). The SEC argued that section 12(d)(3)’s practical effect is to “eliminate the possibility of certain reciprocal practices between investment companies and securities related businesses.” These reciprocal practices “include the possibility that an investment company might purchase securities or other interests in a broker-dealer for selling fund shares, rather than solely on investment merit. Similarly, the staff has expressed concern that an investment company might direct brokerage to a broker-dealer in which the company has invested to enhance the broker-dealer’s profitability or to assist it during financial difficulty, even though that broker-dealer may not offer the best price and execution.”

There do not appear to be any statements in the section 12(d)(3) legislative history, the general legislative history of

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29 Id.
30 Id.
the Investment Company Act or the preamble to the Act to support the argument that section 12(d)(3) was designed to prevent investment companies from engaging in reciprocal practices. Perhaps this is because these practices can be adequately addressed elsewhere. For example, the Conduct Rules of the National Association of Securities Dealers, Inc., expressly prohibit broker-dealer member firms from conditioning the sale of investment company shares on the receipt of brokerage commissions.31

4. Liquidity

The Commission also has argued that "Congress in prohibiting investment in securities related businesses under Section 12(d)(3) was apparently concerned, among other things, with an investment company's maintaining the liquidity of its portfolio."32 This perhaps is the least supportable argument that the SEC has formulated to date to explain the underlying purpose of section 12(d)(3). First, there is nothing in the legislative history to support this argument. Second, the prohibitions contained in section 12(d)(3) apply to all registered investment companies, while liquidity concerns typically arise solely in connection with open-end funds that offer redeemable securities. Finally, those liquidity concerns that do arise in connection with open-end funds specifically are addressed in other provisions of the Investment Company Act.33

31 See NASD Conduct Rule 2830(k).
33 For example, the Commission has interpreted Investment Company Act section 22(e) to prohibit open-end investment companies from investing more than 15% of their assets (10% in the case of money market funds) in illiquid securities. See, e.g., Revisions of Guidelines to Form N-1A, Investment Company Act Release No. 18,612, 57 Fed. Reg. 9828 (Mar. 12, 1992). Section 22(e) provides that investment companies may not suspend the right of redemption or postpone the date of payment more than seven days after a shareholder tenders a security for redemption. 15 U.S.C. § 80a-22(e) (1999).
5. Affiliated Transactions

One final argument which has been considered, but consistently rejected, by the Commission and its staff is that section 12(d)(3) was principally designed to prohibit transactions between investment companies and affiliated persons engaged in securities related businesses. In this connection, the SEC staff stated in a 1979 report to the Commission on section 12(d)(3) that

[s]uch an interpretation does not comport with the language of the section, which by its terms applies to any person who is a broker, dealer, underwriter, or investment adviser. Moreover, because Section 17(a) of the Act prohibits affiliated persons of registered investment companies from selling securities or other property to such investment companies or their controlled companies (with certain exceptions not relevant here), Section 12(d)(3) would be largely redundant if it were meant to be limited to the securities of affiliates.\(^3\)

III. STATUTORY INTERPRETATIONS

Section 12(d)(3) applies only to transactions wherein a registered investment company or a company controlled by such company purchases or otherwise acquires securities or other interests in a securities related business. This section summarizes Commission and staff interpretations pertaining to the concepts of (i) purchasing or otherwise acquiring, (ii) securities or other interests (iii) in a securities related business. Interpretations of the exemptions provided by sections 12(d)(3)(A) and (B) are also set forth.

\(^3\) See Report of the Division of Investment Management RE: Letters from Certain Securities Industry Firms Requesting Modification of, or Exemption From, Section 12(d)(3) of the Investment Company Act of 1940.
A. **Section 12(d)(3) Elements**

1. **Purchase or Otherwise Acquire**

The prohibitions of section 12(d)(3) extend not only to purchases of interests in securities related businesses, but also to mere acquisitions of such interests. Accordingly, the Commission has taken the position since 1962 that the section 12(d)(3) prohibitions apply "not only when a security or interest is originally purchased or acquired, but also when investment companies, or controlled companies thereof, hold an interest in a portfolio company which thereafter by merger, consolidation, reorganization, ... or otherwise, acquires an interest in a dealer, broker, underwriter or investment adviser." Therefore, "investment companies and companies controlled thereby should take such steps as are necessary to divest themselves of such prohibited interests within a reasonable period of time." Consistent with this interpretation the staff has granted no-action relief under section 12(d)(3) to investment companies unable to immediately dispose of interests in securities related business acquired through corporate restructurings due to circumstances beyond their control and permitted disposition in a reasonable time period.

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35 The Investment Company Act does not define the term "purchase." However, section 2(a)(34) of the Act defines the term "sale" to include "every contract of sale or disposition of . . . a security . . . for value." 15 U.S.C. § 80a-2(a)(34) (1999).


37 Id.

In addition to acquisitions through merger, reorganization or consolidation, the Commission and its staff have maintained since 1962 that

[j]ince the prohibition includes both direct and indirect purchases or other acquisitions of interests in the businesses mentioned, investment companies should be especially careful to explore the businesses of companies in which they are considering acquiring an interest, including businesses in which such companies, in turn, have an interest by stock ownership or otherwise. 39

Thus, for example, the SEC staff has indicated that "if an investment company has any ownership interest in an investment adviser, it is indirectly engaged in the business of an investment adviser and, thus, a securities related business." 40 This is so despite the fact that, while section 12(d)(3)'s literal terms extend to any purchase or other acquisition, they do not purport to extend to mere indirect investments in securities related businesses.

2. Securities or Other Interests

Section 12(d)(3) imposes broad restrictions on the types of investments that are prohibited for investment companies. By its terms, the section prohibits purchases not only of the more common types of securities, such as equity and debt securities, but also of any other interest. The most significant Commission staff interpretations of this provision of section 12(d)(3) relate to investment company participation in repurchase agreements. 41 The staff, however, also has granted no-action relief under section 12(d)(3) where an affiliate of an investment adviser to an investment company has a contingent contractual obligation to purchase certain fixed income obligations. 42

41 See discussion of repurchase agreements in Part IV.C., infra.
The staff reasoned that the investment company would not be prohibited from purchasing the bonds for which the affiliate of its adviser had a contingent contractual obligation, because the contingent contractual obligation was sufficiently attenuated so as not to rise to the level of an "interest" in the adviser's affiliate.

3. Securities Related Businesses

Section 12(d)(3) prohibits investments by investment companies in interests in "any person who is a broker, a dealer, is engaged in the business of underwriting, or is either an investment adviser of an investment company or an investment adviser registered under Title II of this Act . . . ."^{43} Each of these entities is discussed in more detail below.

The term "broker" includes any person "engaged in the business of effecting transactions in securities for the account of others, but does not include a bank or any person solely by reason of the fact that such person is an underwriter for one or more investment companies."^{44} The term "bank" encompasses any banking institution organized under U.S. law, a member bank of the Federal Reserve System or any other U.S. banking institution or trust company a substantial portion of whose business consists of taking deposits or exercising fiduciary powers similar to those of national banks.^{45} The term bank does not encompass foreign banking institutions. Thus, the prohibitions of section 12(d)(3) would appear to apply to acquisitions of interests in any foreign banking institution that acts as a securities broker.

The term "dealer" encompasses "any person regularly engaged in the business of buying and selling securities for his own account, through a broker or otherwise, but does

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not include a bank, insurance company, or investment company, or any person insofar as he is engaged in investing, reinvesting, or trading in securities, or in owning or holding securities, for his own account, either individually or in some fiduciary capacity, but not as a regular business. The term “insurance company” is defined to include any entity organized as an “insurance company, whose primary and predominant business activity is the writing of insurance or the reinsuring of risks ... and which is subject to supervision by the insurance commissioner ... of a State.”

An “underwriter” is broadly defined as “any person who has purchased from an issuer with a view to, or sells for an issuer in connection with, the distribution of any security, or participates or has a direct or indirect participation in any such undertaking, or participates or has a participation in the direct or indirect underwriting of any such undertaking.”

The term “investment adviser to an investment company” encompasses any investment adviser to an investment company registered with the Commission under the Investment Company Act. It does not encompass acquisitions of interests in issuers that act as adviser only to entities excluded from the definition of investment company under section 3(c) of the Act or exempted from registration under section 6(c) of the Act. For example, it does not encompass providing investment advice only to entities excluded from the definition of investment company under Investment Company Act section 3(c)(1) because they have 100 or fewer investors and do not propose to make a public offering of their securities.

The Commission adopted Investment Company Act rule 2a-3 in 1944 to exclude certain banks from the definition of "investment adviser" of an investment company for purposes of section 12(d)(3). As a result, the rule permitted investment companies to acquire securities and other interests in banks that served as investment advisers to investment companies other than those seeking to rely on the rule. The Commission rescinded rule 2a-3 in 1984 when it adopted rule 12d3-1. Finally, an "investment adviser registered under Title II of this Act" refers to any investment adviser registered with the Commission under the Investment Advisers Act of 1940 ("Investment Advisers Act"). The SEC staff has indicated that the prohibitions of section 12(d)(3) do not apply to acquisitions of interests in lawfully unregistered investment advisers to unregistered investment companies, such as interests in foreign investment advisers to foreign unregistered investment companies.

B. SECTIONS 12(d)(3)(A) AND (B)

Sections 12(d)(3)(A) and (B) exempt from the prohibitions of Section 12(d)(3) transactions in which one or more investment companies acquire securities of a wholly owned corporation (i) primarily engaged in the business of underwriting and distributing securities issued by other persons, selling securities to customers, or any one or more of these or related activities, and (ii) whose gross income normally is derived principally from these activities.

The Commission and its staff have provided very little guidance concerning the scope of the exemption provided by sections 12(d)(3)(A) and (B). This undoubtedly is attributable, in part, to the fact that very few investment companies have sought to form wholly-owned

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52 Royce Value Fund (Jan. 24, 1995).
underwriting subsidiaries in reliance on this exemption. In fact, as of the date of publication of this article, there appears to be only a single investment company complex that currently wholly-owns and operates an underwriting subsidiary. Moreover, this complex, the Vanguard Group, technically was unable to rely on sections 12(d)(3)(A) and (B) because the subsidiary was not primarily engaged in the business of underwriting securities of other persons. Rather, the subsidiary's principal function is to provide "management, administrative and marketing services on an at-cost basis to the funds."\(^5\) Consequently, this complex has sought and obtained SEC exemptive relief from section 12(d)(3) and certain other Investment Company Act provisions to organize and operate the subsidiary.\(^4\)

IV. INVESTMENT COMPANY ACT RULE 12d3-1

A. INTRODUCTION

The Commission adopted Investment Company Act rule 12d-1 in 1964 to provide an exemption for investment company acquisitions of securities or other interests in issuers that derived no more than 15% of their gross revenues from securities related businesses.\(^6\) Unlike rule 2a-3, this exemption was not limited to acquisitions of bank securities or interests.


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The Commission redesignated rule 12d-1 as rule 12d3-1 in 1984 and made a number of significant revisions to the rule. Most notably, it added an additional exemption from section 12(d)(3) for investment company acquisitions of securities or other interests in issuers that derive more than 15% of their gross revenues from securities related activities. To rely on the new exemption, investment companies had to meet certain quantitative and qualitative conditions. In light of the new exemption, the SEC concurrently rescinded rule 2a-3.

Finally, the Commission substantively amended rule 12d3-1 in 1993 to remove the qualitative conditions that investment companies had to meet to acquire securities or other interests in issuers that derive more than 15% of their gross revenues from securities related activities. The remainder of this section examines the substantive provisions of rule 12d3-1, Commission and staff interpretations under the rule and other relevant exemptions and interpretations under the section and rule.

B. RULE 12d3-1

1. Securities Related Activities

Rule 12d3-1 conditionally exempts from the prohibitions of section 12(d)(3) investment company acquisitions of securities issued by persons engaged in securities related activities. “Securities related activities” are defined as “a person’s activities as a broker, a dealer, an underwriter, an investment adviser registered under the Investment Advisers Act, as amended, or as an investment adviser to a registered investment company.”

Notwithstanding the foregoing, the rule expressly provides that it does not exempt “the acquisition of a general partnership interest or a security issued by the acquiring company’s investment adviser, promoter, or principal underwriter, or any affiliated person of such

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investment adviser, promoter, or principal underwriter.”57 The term “affiliated person” is broadly defined in the Investment Company Act to include all of the following: (i) any person owning 5% or more of an investment company’s outstanding voting securities; (ii) any person 5% or more of whose outstanding voting securities an investment company owns; (iii) any person who controls, is controlled by, or is under common control with, an investment company; (iv) any investment adviser to an investment company; and (v) any officer, director, partner or co-partner or employee of an investment company.58 Thus, rule 12d3-1 does not provide an exemption from section 12(d)(3) for the acquisition of securities of affiliated persons of investment advisers, promoters and principal underwriters, even if such persons are not engaged in a securities related business. However, since the section does not prohibit such acquisitions, no exemption from the section for such acquisitions is necessary.

2. Acquisitions

Rule 12d3-1(d)(7) provides that, subject to limitation under the rule, the following transactions “will not be deemed to be an acquisition of securities of a securities related business”:

(i) the receipt of stock dividends on securities acquired in accordance with the terms of the section;

(ii) the receipt of securities arising from a stock-for-stock split on securities acquired in accordance with the terms of the rule;

(iii) the exercise of options, warrants or rights acquired in accordance with the terms of the section; and

(iv) the conversion of convertible securities acquired in accordance with the terms of the rule.

57 Investment Company Act rule 12d3-1(c), 17 C.F.R. § 270.12d3-1(c) (1999).
In addition to the foregoing, rule 12d3-1 expressly provides that, under certain circumstances, investment company acquisitions of "demand features" or "guarantees," as those terms are defined under Investment Company Act rule 2a-7(a)(8) and (a)(15), will not be deemed to be acquisitions of securities of securities related businesses subject to the rule. An investment company may rely on this exemption regardless of whether it is organized and operated as a money market fund under rule 2a-7. The beneficial effect of this provision is to permit broker-dealers and banks to lend credit support and liquidity to issuers seeking to sell securities eligible for purchase by investment companies.

The term "demand feature" is defined in rule 2a-7 to include any "feature permitting the holder of a security to sell the security at an exercise price equal to the approximate amortized cost of the security plus accrued interest, if any, at the time of exercise." A demand feature

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60 17 C.F.R. §§ 270.2a-7(a)(8) and 270.2a-7(a)(15) (1999).
63 Investment Company Act rule 2a-7(a)(8), 17 C.F.R. § 270.2a-7(a)(8) (1999).
must be exercisable either at any time on no more than 30 calendar days' notice or at specified intervals not exceeding 397 calendar days and upon no more than 30 calendar days' notice.\textsuperscript{64}

The term "guarantee" is defined in rule 2a-7 as "an unconditional obligation of a person other than the issuer of the security to undertake to pay, upon presentment by the holder of the guarantee (if required), the principal amount of the underlying security plus accrued interest when due or upon default."\textsuperscript{65} The Commission has stated that this term "would include a wide-range of arrangements designed to unconditionally support the credit of the issuer of the security."\textsuperscript{66} Thus, for example, the term would encompass unconditional puts, letters of credit or financial guarantee (bond) insurance.\textsuperscript{67}

For purposes of the exemption in rule 12d3-1(d)(7), a demand feature or guarantee is considered to be acquired from the entity to whom the investment company looks for payment of the exercise price. In addition, with respect to 75\% of an investment company's assets immediately after acquisition, no more than 10\% of the company's total assets may consist of securities with underlying demand features or guarantees from the same institution.

3. Exemption for Companies Deriving 15\% or Less of Their Revenues from Securities Related Activities

Rule 12d3-1(a)\textsuperscript{68} provides that, notwithstanding section 12(d)(3), a registered investment company or any company that the investment company controls "may acquire any security issued by any person that, in its most recent fiscal year, derived 15 percent or less of its gross revenues from securities related activities unless the acquiring company

\textsuperscript{64} See id.
\textsuperscript{65} Investment Company Act rule 2a-7(a)(15), 17 C.F.R. § 270.2a-7(a)(15) (1999).
\textsuperscript{67} See id.
\textsuperscript{68} 17 C.F.R. § 270.12d3-1(a) (1999).
would control such person after the acquisition." This provision enables an investment company to purchase securities of issuers which are not engaged in securities related activities, but only to an extent that, in the view of the Commission, does not warrant the protection afforded by section 12(d)(3).

To determine whether a particular issuer meets the 15% or less gross revenue test, an investment company must count the issuer's gross revenues from its own direct securities related activities as well as its "ratable share of the securities related activities of enterprises of which it owns 20 percent or more of the voting or equity interest."69

In addition, the Commission has stated that [w]here an issuer is a subsidiary of a corporation engaged direct [sic] or indirectly in securities related activities, and an investment company knows or has reason to know that the proceeds of securities issued by the subsidiary are to be used to finance the business operations of the parent or its other subsidiaries, then the subsidiary's securities would be deemed to be issued by the parent. The acquisition of such securities would be prohibited under Section 12(d)(3), and would be exempted under [Rule 12d3-1] only to the extent that securities issued directly by the parent corporation would be eligible for purchase under the rule.70

In making the foregoing determinations, an investment company must look to "the issuer's annual report to shareholders, the issuer's annual reports or registration statement filed with the Commission or the issuer's chief financial officer."71

Compliance with these conditions is required only at the time of acquisition. Thus, the Commission has said that "if

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a company were to rely on the blanket exemption in acquiring securities from an issuer that derived 15% or less of its gross revenues from securities related activities, and a year later that issuer’s revenues from such activities exceeded 15%, the company could continue to hold those securities in reliance on the blanket exemption.”72 Of course, the company could not increase its holdings of such securities, however, except in transactions that are not deemed to involve the acquisition of securities of a securities related business.

Finally, the investment company may not control the issuer as a result of the acquisition. Thus, as a practical matter, it may not acquire more than 25% of the outstanding voting securities of the issuer. A “voting security” is defined in section 2(a)(42) of the Investment Company Act as “any security presently entitling the owner or holder thereof to vote for the election of directors of a company.”73 Thus, the rule’s terms do not prohibit an investment company from acquiring more than 25% of the securities of an issuer if such securities are non-voting securities.

4. Exemption for Companies Deriving More than 15% of Their Gross Revenues from Securities Related Activities

Rule 12d3-1(b)74 provides that, notwithstanding section 12(d)(3), an acquiring company may acquire a security issued by a person that, in its most recent fiscal year, derived more than 15% of its gross revenues from securities related activities as long as the following conditions are met.

First, immediately after the acquisition of any security, the acquiring company may not have invested “more than 5 percent of the value of its total assets in the securities of the issuer.”75

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74 17 C.F.R. § 270.12d3-1(b) (1999).
Second, the three day safe harbor for purchases of securities of a single issuer in excess of 5% provided under rule 2a-7 may not be relied upon to exceed the 5% limitation imposed by rule 12d3-1.76

Third, immediately after acquiring any equity security, the acquiring company may not own more than “five percent of the outstanding securities of that class of the issuer’s equity securities.”77 “Equity security” for these purposes is defined to include any stock or similar security ... limited partnership interest, interest in a joint venture, or certificate of interest in a business trust; or any security convertible, with or without consideration into such a security, or carrying any warrant or right to subscribe to or purchase such a security; or any such warrant or right; or any put, call, straddle or other option or privilege of buying such a security from or selling such a security to another without being bound to do so.78

The determination of the percentage of an acquiring company’s ownership interest of a class of outstanding equity securities of an issuer must be determined in accordance with rules adopted by the Commission under section 16 of the Securities Exchange Act of 1934 (“Securities Exchange Act”). Rule 16a-1 under the Securities Exchange Act contains two definitions of the term “beneficial owner.” One definition is used “solely for the purpose of determining whether a person is a beneficial owner of more than ten percent of any class of equity securities”79 and the other is used for all other

purposes under section 16.\textsuperscript{80} Rule 16a-1 does not specify whether an investment company must look to one or both of these definitions for the purpose of determining its ownership interest in an issuer engaged in securities related activities. However, in interpreting another rule provision under the Investment Company Act that incorporates the section 16 rules, the Commission staff concluded that the second definition would be used.\textsuperscript{81} Presumably, the same conclusion should apply for purposes of interpreting rule 12d3-1.

Fourth, immediately after the acquisition of any debt security, the acquiring company may not own "more than 10 percent of the outstanding principal amount of the issuer's debt securities."\textsuperscript{82} "Debt securities" include "all securities other than equity securities."\textsuperscript{83} Investment companies seeking to acquire options, warrants, rights or convertible securities of securities related businesses in reliance on rule 12d3-1 generally must assume that such instruments have been exercised at the time of acquisition for purposes of this exemption. One interesting effect of this requirement is that the Commission staff has agreed that cash settled options issued by broker-dealers may be treated as fixed income securities under rule 12d3-1.\textsuperscript{84} In permitting the fund to treat cash settled options as fixed income securities, the staff relied on representations that, although the value of the options is based on the value of an equity security or a basket of equity securities, the options would at no time "carry any right that typically accompanies an equity security, such as the right to vote or the right to dividends. Rather, they represent only a contractual right to receive a payment if the option is in


\textsuperscript{82}Investment Company Act rule 12d3-1(b)(2), 17 C.F.R. § 270.12d3-1(b)(2) (1999).

\textsuperscript{83}Investment Company Act rule 12d3-1(d)(4), 17 C.F.R. § 270.12d3-1(d)(4) (1999).

the money' when exercised." Since such options would not be viewed as equity securities, the definition of fixed income security provided by rule 12d3-1(d)(4) requires that they be treated as fixed income securities.

C. REPURCHASE AGREEMENTS

In a typical investment company repurchase transaction ("repo"), the investment company purchases securities from a broker, a dealer or a bank and agrees to resell those securities to the same party at a stated higher price on an agreed-upon date, often as soon as the next day. In economic reality, the repo transaction functions much like a loan by the investment company to the selling broker, dealer or bank secured by the securities transferred to the investment company. Since a repo agreement with a broker or dealer may be construed as the acquisition of an interest in that broker or dealer, the Commission staff has interpreted section 12(d)(3) and rule 12d3-1 as prohibiting investment companies from entering into such transactions. Similarly, where an investment company enters into a repurchase agreement with a bank that is engaged in a securities related business, including dealing in government securities, that transaction may be construed as the acquisition of an interest in a securities related business.

Notwithstanding the foregoing, the Commission staff historically has taken the position that it will not recommend enforcement action to the SEC against an investment company that enters into a repo transaction with a broker, dealer or bank engaged in a securities related business, provided that the agreement is fully collateralized and the issuer is a creditworthy entity (the "Current Interpretation"). The Commission recently

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85 Id.
proposed Investment Company Act rule 5b-3 to codify this interpretation.  

1. Fully Collateralized

Under the Current Interpretation, a repo agreement will be considered fully collateralized only if the market value of the securities held as collateral, plus any accrued interest on those securities, is equal to or greater than the amount at which the broker, dealer or bank will repurchase the securities or repay the principal amount borrowed plus interest accrued on the principal amount borrowed ("repurchase price"). The market value of the securities held as collateral must be marked to the market daily during the entire term of the agreement and the repo agreement should provide that additional collateral will be required from the broker, dealer or bank if the market value of the securities falls below the repurchase price.

In addition, the staff will consider a repo agreement to be fully collateralized only if the investment company has acquired actual or constructive possession of the collateral. Constructive possession includes the transfer of United States government securities by book-entry. Where the collateral is not held in the possession of the investment company or its custodian, the collateral must be held by a third party which is eligible to serve as a custodian under the Investment Company Act and which has verified that the collateral is being held for the investment company.

(Feb. 2, 1983). In this regard, a note following the text of Investment Company Act rule 12d3-1 currently states that "[i]t is not intended that this rule should supersede" the staff's no-action position pertaining to repo agreements.

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Under the Proposed Rule, a repo agreement will be considered “fully collateralized” if the following conditions are met:

(i) the value of the securities collateralizing the repurchase agreement (reduced by the transaction costs (including loss of interest) that the investment company reasonably could expect to incur if the seller defaults) is, and during the entire term of the repo agreement remains, at least equal to the resale price provided in the agreement;

(ii) the investment company has perfected its security interest in the collateral;

(iii) the collateral is maintained with the investment company’s custodian or a third party that qualifies as a custodian under the Investment Company Act;

(iv) the collateral consists entirely of cash items, United States government securities or other securities that at the time the repo agreement is entered into are rated in the highest rating category by the Requisite NRSROs; and

(v) upon an event of insolvency with respect to the seller, the repurchase agreement would qualify under a provision of applicable insolvency law providing an exclusion from any automatic stay of creditors' rights against the seller.

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90 Proposed Rule 5b-3(c)(7) would define the term "resale price" as the acquisition price paid to the seller of the securities, plus the accrued resale premium on such acquisition. The accrued resale premium is the amount specified in the repo agreement or the amortization of the difference between the acquisition price and the resale price specified in the repo agreement.

91 Proposed Rule 5b-3(c)(6) would define the term "requisite NRSRO" as any two nationally recognized statistical rating organizations that have issued a rating with respect to a security or class of debt obligations of an issuer, or if only one nationally recognized statistical rating organization has issued a rating with respect to such security or class of debt obligations of an issuer at the time the investment company acquires the security, that NRSRO.
The term "event of insolvency" means, with respect to a person, one of the following:

(i) an admission of insolvency, the application by the person for the appointment of a trustee, receiver, rehabilitator, or similar officer for all or substantially all of its assets, a general assignment for the benefit of creditors, the filing by the person of a voluntary petition in bankruptcy or application for reorganization or an arrangement with creditors; or

(ii) the institution of similar proceedings by another person which are not contested; or

(iii) the institution of similar proceedings by a government agency responsible for regulating the activities of the person, whether or not contested by the person.

2. **Creditworthiness**

In addition to ensuring that repo agreements are fully collateralized, the Commission staff has taken the position that it is necessary for funds to evaluate the creditworthiness of the brokers, dealers and banks with whom they propose to enter into repos. The staff historically took the position that the fund's board of directors should perform the evaluation of creditworthiness. In a recent interpretive letter, however, the staff revised this position to permit a fund's investment adviser, rather than the fund's board, to evaluate the creditworthiness of repo counterparties and otherwise assume primary responsibility for monitoring and evaluating the fund's use of repo agreements.\(^9\) The Proposed Rule would formalize the interpretation set forth in this letter.

In evaluating the creditworthiness of a counterparty the fund's board or its delegate should determine that the

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counterparty presents no serious risk of becoming involved in bankruptcy proceedings within the time frame contemplated by the repo agreement. The staff recognizes that “the evaluation of the creditworthiness of repo issuers is a difficult task that may involve subjective judgments as well as consideration of available financial information.”

D. INDEX FUNDS

As noted above, rule 12d3-1 does not exempt the acquisition of a security issued by the acquiring investment company’s investment adviser, promoter, or principal underwriter, or any affiliated person of such persons. This provision has proven particularly troublesome for investment companies that seek to replicate the performance of broad based market indices comprised of securities issued by, among others, a parent or other affiliated companies of the investment advisers, promoters or principal underwriters to the investment companies. For example, in 1990, the Large Company Index Fund, an investment portfolio of IBM Mutual Funds requested permission from the Commission staff under section 12(d)(3) and rule 12d3-1 to invest in shares of common stock issued by International Business Machines Corporation, the parent company of the Large Company Index Fund’s investment adviser. The Large Company Index Fund argued that its investment objective was to replicate the performance of the Standard & Poor’s 500 Composite Stock Price Index ("S&P 500") and that the staff’s refusal to permit the acquisition of IBM common stock would effectively preclude it from acquiring an integral component of that index. Since 1990, several other S&P 500 index funds have sought similar relief. In each case, the staff has agreed not to recommend enforcement action under section 12(d)(3) or rule 12d3-1, based on the following representations:

93 Id.
(i) the fund's investment objective is to match the performance of an unaffiliated, broad-based index;

(ii) the fund will purchase securities of the affiliated person of its investment adviser, promoter or principal underwriter and maintain its position in such securities only in the approximate percentage that the securities are represented on the index; and

(iii) any purchase of the securities of an affiliated person of the fund's investment adviser, promoter or principal underwriter will comply with the requirements of rule 12d3-1(a), which permits investment company acquisitions of securities of issuers that derived 15% or less of their gross revenues from securities related businesses.

In contrast, the Commission staff has declined to grant no-action relief under section 12(d)(3) or rule 12d3-1 to index funds that seek to acquire securities of affiliated persons of their investment advisers, promoters or principal underwriters in percentages that differ from those that the securities represent on the index. Thus, for example, the staff declined to grant no-action relief to permit a series of unit investment trusts to invest 10% of their assets in each of the ten stocks in the Dow Jones Industrial Average with the highest dividend yields where one or more of the securities could be securities issued by affiliated persons of the trust sponsors.96

Having stated its views concerning the application of section 12(d)(3) and rule 12d3-1 to index fund acquisitions of securities of investment adviser, promoter and principal underwriter affiliates, the Commission staff has concluded that it will no longer respond to no-action requests in this area unless they present novel issues.97


97 The Victory Stock Index Fund, SEC No-Action Letter (Feb. 7, 1995). It is interesting to note that, in 1993, one commentator requested that the SEC consider amending Investment Company Act rule 12d3-1 "to permit a fund to invest its portfolio assets in a manner designed to
E. Money Market Funds

As noted above, the Commission staff historically has taken the position that investment companies may not enter into a repo agreement with a broker, dealer or bank engaged in securities related activities unless the agreement is fully collateralized and the issuer is a creditworthy entity. In conjunction with its recent proposed adoption of Investment Company Act rule 5b-3, the Commission also proposed amending rule 2a-7 to require a fund’s board of directors or the board’s delegate to evaluate the counterparty’s creditworthiness. In addition, the proposed rule would amend the current definition of “collateralized fully” under rule 2a-7 to cross reference the one set forth in proposed Investment Company Act rule 5b-3, because the definition set forth in the proposed rule is virtually identical to the one currently contained in rule 2a-7.

V. Enforcement Proceedings

There do not appear to be any federal or state court cases to date involving section 12(d)(3) or rule 12d3-1. However, the Commission has instituted enforcement proceedings for violations of the section or rule on at least five occasions. Most recently, the Commission instituted proceedings in 1985 against an investment adviser to a registered investment company and an officer of the

replicate a nationally recognized index.” Investment Company Act Release No. 19,716, supra note 4. The SEC stated at that time that it “believes this is worthy of further examination, but is not within the scope of the proposed amendments. Accordingly, the Commission is not taking action on the commentor’s proposal in this rulemaking.” Id.

98 See Proposed Rule 2a-7(c)(4)(ii).
99 Proposed Rule 2a-7(a)(5).
100 See Investment Company Act rule 2a-7(a)(5), 17 C.F.R. § 270.2a-7(a)(5).
adviser for causing the fund to purchase a "subordinated debenture issued by a corporation which derived more than 15% of its total gross revenues from the business of being a broker, dealer or underwriter." This proceeding occurred prior to adoption of the amendments to rule 12d3-1 permitting investments in securities related businesses that derived more than 15% of their gross revenues from securities related activities subject to a 5% limitation.

VI. CONCLUSION

As noted at the beginning of this article, the first and perhaps most fundamental canon of statutory construction is that "when language is clear and unambiguous it must be held to mean what it plainly expresses." For the most part, the Commission and its staff have adhered to this canon admirably in interpreting and applying section 12(d)(3). Moreover, they have shown flexibility and creativity in administering section 12(d)(3) and rule 12d3-1 in light of the many fundamental changes to the securities markets since 1940. Most recently, this has centered on proposed Investment Company Act rule 5b3-1, which would codify and update the Commission staff positions pertaining to investments in repurchase agreements.

At the same time, the Commission and its staff have disregarded the literal terms of rule 12d3-1 in one important area — they have interpreted and applied section 12(d)(3) to acquisitions of interests in securities related businesses through indirect ownership. This interpretation undoubtedly was prompted by the fact that Congress intended the Investment Company Act to prevent investment companies from being "organized, operated, managed, or their portfolio securities selected in the interests of brokers, dealers, underwriters, and investment advisers." Unfortunately, it is inconsistent with another

103 See SUTHERLAND, supra note 9, at § 81.
important canon of statutory construction — that the literal terms of a statute should be disregarded only “if the plain meaning of the words of the statute is at variance with the policy of the statute or if there is a clearly expressed legislative intention contrary to the language of the statute.”

As noted above, the legislative history is virtually silent concerning the intended policy and scope of section 12(d)(3). While the SEC and its staff have advanced several arguments to explain the policy and purpose of the section, only one of the arguments is somewhat persuasive — that section 12(d)(3) was designed to prevent investment companies from directly engaging in diverse financial enterprises.

In light of the paucity of section 12(d)(3) legislative history and the inherent weaknesses in most of the explanations for that section by the Commission and its staff, it is difficult to conclude that the interpretation discussed is warranted. A plain reading of section 12(d)(3) certainly does not warrant such a conclusion, nor does the legislative history.

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105 See SUTHERLAND, supra note 9, at § 81.