U.S. Regulation of the International Securities and Derivatives Markets, § 15.01, INTRODUCTION

U.S. Regulation of the International Securities and Derivatives Markets
1 Edward F. Greene, Alan L. Beller, Edward J. Rosen, Leslie N. Silverman, Daniel A. Braverman, Sebastian R. Sperber, Nicolas Grabar & Adam E. Fleisher, U.S. Regulation of the International Securities and Derivatives Markets § 15.01 (11th and 12th Editions 2014-2017)
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The Investment Company Act, the primary source of U.S. regulation of collective investment vehicles, [1] was adopted to curtail the securities fraud that existed in the 1930s and earlier in pooled investment funds offered in the U.S. retail market. The Investment Company Act is designed to provide a detailed regulatory scheme addressed at specific industry ills through a combination of registration and disclosure requirements and ongoing substantive regulation.

The Investment Company Act regulates companies identified as investment companies either by their purpose or by virtue of the makeup of their assets. As a result, companies, including operating companies, that are not funds (so-called "inadvertent investment companies") may fall within the Investment Company Act's definition of investment company. Companies that hold minority interests and other investment securities that account for as little as 40% of the value of their assets may be required to register as investment companies and become subject to substantive regulation. The regulatory requirements for companies registered under the Investment Company Act are extremely restrictive and, as a practical matter, are impossible for foreign companies to meet. The critical areas of inquiry for a foreign company therefore are whether it (or the affiliate, subsidiary or parent company involved in a particular transaction) falls within the definition of investment company, and, if so, whether it can avail itself of any of the provisions of the Investment Company Act or the rules thereunder, or obtain a specific order of the SEC, excluding it from the definition of investment company or exempting it from regulation.

In the early 1990s, the Investment Company Act was the subject of special scrutiny by the SEC staff and market participants. This scrutiny was largely directed at the criteria used to determine whether registration was required under the Act and the scope and limited number of exemptions from registration that were available. A 1990 SEC "concept release" (the "Concept Release") [2] soliciting public comment regarding the continued workability of the Investment Company Act generated significant commentary by professionals active on both the "buy" and "sell" sides of the industry, regulatory and self-regulatory authorities, the private bar and academics. The staff subsequently issued a major evaluation of the Investment Company Act entitled PROTECTING INVESTORS: A HALF CENTURY OF INVESTMENT COMPANY REGULATION (the "1992 Report") [3] that included

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recommendations for various rulemaking and legislative initiatives. Although some of these proposals were implemented, action has not been taken with respect to many others, including, notably, certain of the staff's recommendations regarding the treatment of both private and public investment funds organized outside the United States. [4]

Before the SEC could act further, the National Securities Markets Improvements Act of 1996 (the "NSMIA") [5] very significantly amended the Investment Company Act. The changes made by the NSMIA included the addition of a new exemption from registration under the Investment Company Act for investment companies whose securities are offered and sold privately only to institutions and individuals with high net worth and significant investments, the addition of an exemption for dealers principally in derivative instruments, the substantial reduction of state regulation of SEC-registered public investment companies and the relaxation of restrictions on investments by one investment company in securities of another investment company. Although none of the amendments was targeted at international markets or international activities, several of the changes, including in particular the first two mentioned above, have had a significant impact on the operation of the Investment Company Act in the international context.

Even after these changes, however, the efficacy of the Investment Company Act continues to be scrutinized by Congress and other market participants with a special focus on open-end investment companies, better known as mutual funds. In late 2002, attention focused on the failure of many mutual funds and brokers to provide promised volume-based discounts (so-called "breakpoints") on sales fees charged to qualifying investors who acquired fund shares. More significantly, during the second half of 2003, a series of abuses involving mutual funds and their investment advisers came to light as a result of an investigation by the New York Attorney General, prompting the SEC to initiate numerous enforcement proceedings. [6] In general, investors are able to purchase or redeem the shares of a mutual fund that they hold at a price based on the fund's net asset value determined as of a specified time after the order is submitted. It was discovered, however, that certain mutual funds, their advisers or dealers were permitting favored investors to engage in "late trading," whereby the investors would purchase or redeem mutual fund shares based on the fund's old net asset value after the time on each day as of which the fund's new net asset value would

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have been applicable. [7] This late trading permitted the favored investors to take advantage of market events that occurred after the fund's net asset value had been determined by, for example, purchasing shares at the old net asset value if subsequent events would cause the new net asset value to be higher or redeeming shares at the old net asset value if subsequent events would cause the new net asset value to be lower. [8] Cases also arose where investment advisers or dealers allowed investors to engage in or facilitated short-term trading in mutual fund securities in violation of stated fund policies to the detriment of other fund investors and in breach of the fiduciary duties owed by the adviser to the fund and its shareholders. [9] These so-called "market timing" practices were especially pronounced in funds that invested in non-U.S. securities, where investors would seek to take advantage of time-zone differences between the markets where the fund's portfolio securities traded and the specified time in the United States as of which the fund's net asset value was determined. There were also allegations that certain investment advisers selectively disclosed the content of fund portfolios to attract investments from large investors, potentially allowing those investors to trade against the fund. [10]

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In addition to instituting numerous enforcement proceedings, the SEC engaged in a flurry of rulemaking, ranging from mutual fund governance reforms [11] and mandating or prohibiting certain pricing and payment arrangements [12] to enhanced disclosure of fund fee structures, trading policies and conflicts of interest. [13]

Most of the Investment Company Act's provisions address the operation of funds offered to the U.S. public. Hedge funds, however, which generally are

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private funds, have also attracted Congressional and regulatory attention. [14] These funds, which are often organized outside the United States, rely substantially on leverage (directly and through the use of complex derivative instruments) to increase potential investment returns. The investment strategy of hedge funds, which are offered to sophisticated high net worth individuals and institutions worldwide under exemptions from regulation under the Investment Company Act, may also present a significant risk of loss. In one case involving a U.S.-based hedge fund, Long-Term Capital Management, Inc., the losses incurred were of sufficient size to have a potential systemic impact on the global financial markets and necessitated a rescue that was coordinated by the Federal Reserve Bank of New York. [15] A 2003 study by the SEC staff that examined hedge fund operations and the role that hedge funds played in the late trading and market-timing cases involving mutual funds intensified this scrutiny. [16] SEC concerns over the growth in assets managed by hedge funds, an increasing number of cases involving fraud at hedge funds and the rise in the number of retail investors exposed to hedge funds resulted in a rule that required hedge fund advisers to register under the Investment Advisers Act of 1940, [17] although this rule was later vacated by the U.S. Court of Appeals for the District of Columbia Circuit.

More recently, the SEC has adopted regulatory reforms aimed at addressing the trouble that money market mutual funds experienced during the financial crisis of 2008. For the first time, a money market mutual fund "broke the buck" (allowed its net asset value per share ("NAV") to fall below $1.00), [18] leading to a temporary loss of confidence in such funds generally and necessitating a federal rescue program to preserve liquidity and stability in the money market mutual fund market. [19] In July 2014, however, the SEC adopted new rules applicable to money market funds that require institutional money market funds that do not principally invest in U.S. government securities to transact at a floating

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NAV, [20] give money market funds the ability to impose liquidity fees and suspend redemptions in certain circumstances, govern valuation of such funds, and provide for new disclosure, stress testing, reporting and diversification requirements. [21] In October 2016, the SEC adopted rules to address risk management and liquidity requirements [22] and "swing pricing" for open-end funds and exchange-traded funds, [23] and to require enhanced disclosure. [24] Additionally, the SEC has proposed rules that would regulate the use of derivatives by registered investment companies. [25]

The Dodd-Frank Act made few modifications to the Investment Company Act. Most notably, the Investment Company Act was amended to remove any reliance on ratings provided by national registered statistical rating organizations ("NRSROs"). [26] The SEC has revised certain Investment Company Act rules to eliminate reliance on rating agencies, as mandated by the Dodd-Frank Act, [27] but has yet to take action with respect to other rules. [28] The other notable change made by the Dodd-Frank Act was to include aiding and abetting liability for persons assisting others in violating provisions of the Investment Company Act or the rules promulgated thereunder. [29]

Footnotes

1 Operators of funds that utilize commodity futures contracts and commodity options, including security futures products, even if only for hedging or other portfolio management purposes, may also be subject to regulation as commodity pool operators under the Commodity Exchange Act ("CEA"). The Investment Company Act, Pub. L. No. 76-768, was originally passed on August 22, 1940.

2 SEC Release No. IC-17534 (June 15, 1990).

3 SEC Division of Investment Management, PROTECTING INVESTORS: A HALF CENTURY OF INVESTMENT COMPANY REGULATION (May 1992) (the "1992 Report"). The 1992 Report also addressed various aspects of U.S. investment adviser regulation, which are discussed in Chapter 16.

4 *See* §§ 15.03, 15.06 and 15.08.

5 National Securities Markets Improvements Act of 1996, Pub. L. No. 104-290, 110 Stat. 3416, 3426–27 (1996).

6 *See* SEC Release No. IC-26520 (July 27, 2004), 69 Fed. Reg. 46,378, 46,378 n.6 (Aug. 2, 2004) (collecting cases).

7 Rule 22c-1 under the Investment Company Act requires that a mutual fund sell and redeem shares at the net asset value next computed after the order is placed or the security is tendered. For example, if a mutual fund calculates its net asset value at 4:00 p.m., any orders to purchase or redeem shares in that mutual fund received after 4:00 P.M. should be satisfied using the net asset value calculated at 4:00 P.M. on the next day.

8 *See, e.g.*, *In the Matter of Bear, Stearns & Co. Inc.*, SEC Release No. IC-27262 (Mar. 16, 2006) (finding that, from 1999 through September 2003, Bear Stearns facilitated trading by certain of its prime brokerage customers and customers of certain correspondent broker-dealers to benefit those customers at the expense of mutual fund shareholders, and ordering $250 million in disgorgement and penalties); *In the Matter of Banc of America Capital Management, LLC*, SEC Release No. IC-26756 (Feb. 9, 2005) (finding that, from as early

as July 2000 through July 2003, certain Bank of America entities allowed favored large investors to engage in market timing and late trading activities with respect to mutual funds that they advised or distributed, and ordering payment of $375 million).

9 *See, e.g.*, *In the Matter of Bear, Stearns & Co. Inc.*, SEC Release No. IC-27262 (Mar. 16, 2006); *In the Matter of Banc of America Capital Management, LLC*, SEC Release No. IC-26756 (Feb. 9, 2005); *In the Matter of Massachusetts Financial Services Co.*, SEC Release No. IC-26347 (Feb. 5, 2004) (finding that, from at least late 1999 to October 2003, Massachusetts Financial Services allowed widespread market timing and late trading in certain of its funds, and ordering payment of $225 million). In some cases, advisors allowed "market timing" transactions by investors in exchange for placing long-term "sticky" assets in other funds managed by the adviser. *In the Matter of Columbia Management Advisors, Inc.*, SEC Release No. IC-26752 (Feb. 9, 2005) (finding that, from at least 1998 to October 2003, Columbia entities (i) allowed preferred customers to engage in market timing transactions with respect to certain Columbia funds in exchange for maintenance of "sticky" assets in other funds and (ii) disclosed material nonpublic portfolio holding information to various entities, and ordering payment of $140 million).

10 *See, e.g., In the Matter of Gary L. Pilgrim*, SEC Release No. IC-26655 (Nov. 17, 2004); *In the Matter of Harold J. Baxter*, SEC Release No. IC-26656 (Nov. 17, 2004); *In the Matter of Pilgrim Baxter & Associates, Ltd.*, SEC Release No. IC-26470 (June 21, 2004) (series of enforcement proceedings finding the existence of market timing and self-dealing practices with respect to funds advised by an investment adviser and its principals from at least June 1998 to December 2001, including disclosure of material nonpublic information regarding the composition of portfolio holdings to a certain broker, and ordering total payments of $250 million); *see also In the Matter of Alliance Capital Management, L.P.*, SEC Release No. IC-26312A (Jan. 15, 2004) (finding that an investment adviser permitted select investors to engage in market timing transactions in exchange for maintenance of "sticky" assets in other funds, finding further that the investment adviser divulged material nonpublic information about portfolio holdings, and ordering payment of $250 million).

11 *See* SEC Release No. IC-26520 (July 27, 2004) (adopting rules designed to increase the independence and effectiveness of the boards of directors of registered investment companies); SEC Release No. IC-26299 (Dec. 17, 2003) (requiring registered investment companies to adopt written compliance procedures and designate a chief compliance officer); *see also* SEC Release No. IC-26985 (June 30, 2005) (reconsidering certain aspects of fund governance reforms following remand from the U.S. Court of Appeals for the D.C. Circuit).

12 *See* SEC Release No. IC-27504 (Sept. 27, 2006) (adopting rule requiring mutual funds to, among other things, enter into shareholder information agreements with intermediaries, such as broker-dealers, that hold shares on behalf of other investors in so-called "omnibus accounts," whereby the intermediaries must provide the mutual funds access to information about transactions in such accounts to enable the mutual fund to enforce restrictions on market timing and similar abusive transactions); SEC Release No. IC-26782 (Mar. 11, 2005) (adopting rule requiring, with certain exceptions, a mutual fund's board of directors either to impose a redemption fee of up to 2% on mutual fund shares redeemed within seven or more calendar days of their purchase or determine that imposition of a redemption fee is not necessary or appropriate); SEC Release No. IC-26591 (Sept. 2, 2004) (adopting rules to prohibit open-end management investment companies from paying for the distribution of their shares with brokerage commissions).

13 *See* SEC Release No. IC-26533 (Aug. 23, 2004) (adopting amendments to forms under the Investment Company Act to enhance disclosure by registered management investment companies regarding their portfolio managers); SEC Release No. IC-26486 (June 23, 2004) (adopting rule and form amendments to enhance disclosure by registered management investment companies regarding investment advisory contracts); SEC Release No. IC-26464 (June 7, 2004) (adopting form amendments requiring disclosure of volume-based "breakpoint" discounts by mutual funds); SEC Release No. IC-26418 (Apr. 16, 2004) (adopting form amendments requiring disclosure with respect to policies regarding market timing and selective disclosure of portfolio holdings); SEC Release No. IC-26372 (Feb. 27, 2004) (adopting rule and form amendments requiring disclosure by registered management investment companies with respect to costs, portfolio investments and past performance); *see also* SEC Release No. IC-26778 (Feb. 28, 2005)

(reopening comment period on proposed rules that would require broker-dealers to provide customers information regarding the costs and conflicts of interest that arise from, among other things, the distribution of mutual fund shares).

14 *See, e.g.*, SEC Release No. IA-2333 (Dec. 2, 2004); The Long and Short of Hedge Funds: Effects of Strategies for Managing Market Risk: Hearing Before the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises of the House Committee on Financial Services, 108th Congress (2003); Recent Developments in Hedge Funds: Hearing Before the U.S. Senate Committee on Banking, Housing and Urban Affairs, 108th Congress (2003).

15 *See, e.g.*, *HEDGE FUNDS, LEVERAGE, AND THE LESSONS OF LONG-TERM CAPITAL MANAGEMENT*, Report of the President's Working Group on Financial Markets (Apr. 1999).

16 SEC, Staff Report to the SEC, *IMPLICATIONS OF THE GROWTH OF HEDGE FUNDS* (Sept. 2003).

17 *See* SEC Release No. IA-2333 (Dec. 2, 2004); *see also* § 15.03[3][a][i][A]; *Goldstein v. SEC*, 451 F.3d 873 (D.C. Cir. 2006).

18 Christopher Condon, *Reserve Primary Money Fund Falls Below $1 a Share*, BLOOMBERG NEWS (Sept. 16, 2008).

19 From October 21, 2008 to October 30, 2009, the Federal Reserve Bank of New York's Money Market Investor Funding Facility temporarily provided senior secured funding to qualifying money market mutual funds in order to provide liquidity for investors. *See* the Federal Reserve Bank of New York's description of the program at http://www.federalreserve.gov/monetarypolicy/mmiff.htm.

20 Money market funds that invest at least 99.5% of their total assets in cash, government securities, and/or repurchase agreements that are ''collateralized fully" (meaning collateralized by cash or government securities) are exempt from the requirement to transact at a floating NAV and the provisions regarding redemption fees and gates. *See* 79 Fed. Reg. 47,736, 47,791 (Aug. 14, 2014).

21 SEC Release No. IC-31166 (July 23, 2014).

22 SEC Release No. 33-10233 (Oct. 13, 2016).

23 SEC Release No. 33-10234 (Oct. 13, 2016).

24 SEC Release No. 33-10231 (Oct. 13, 2016).

25 SEC Release No. IC-31933 (Dec. 11, 2015).

26 § 939(c) of the Dodd-Frank Act.

27 § 939A of the Dodd-Frank Act (requiring the SEC to remove reliance on credit ratings from rules); SEC Release No. IC-30847 (Dec. 27, 2013) (Rule 5b-3 and forms for registration of investment companies under the Investment Company Act to eliminate reliance on credit ratings); SEC Release No. IC-31828 (Sept. 16, 2015) (adopting amendments to Rule 2a-7 (relating to money market mutual funds) SEC Release No. IC-30268 (Nov. 19, 2012) (adopting Rule 6a-5 (relating to business and industrial development companies).

28 *See infra* Notes 110 to 112 and surrounding text.

29 § 929M of the Dodd-Frank Act.

U.S. Regulation of the International Securities and Derivatives Markets, § 15.02, DEFINITION OF "INVESTMENT COMPANY"

U.S. Regulation of the International Securities and Derivatives Markets
1 Edward F. Greene, Alan L. Beller, Edward J. Rosen, Leslie N. Silverman, Daniel A. Braverman, Sebastian R. Sperber, Nicolas Grabar & Adam E. Fleisher, U.S. Regulation of the International Securities and Derivatives Markets § 15.02 (11th and 12th Editions 2014-2017)
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The Investment Company Act's definition of "investment company" encompasses any entity that:

> (A) [i]s or holds itself out as being engaged primarily … in the business of investing, reinvesting or trading in securities;
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> … or
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>
> (B) [i]s engaged or proposes to engage in the business of investing, reinvesting, owning, holding, or trading in securities, and owns or proposes to acquire investment securities having a value exceeding 40 per centum of the value of such issuer's total assets (exclusive of Government securities and cash items) on an unconsolidated basis. [30]

The definition does not require that a portfolio be managed, and the requirement of being in the "business" has been interpreted very expansively; it may, for example, be satisfied even by a completely passive trust that simply holds securities [31] or by a holding company.

The wide range of companies covered by the Investment Company Act was thought by Congress to be justified in light of the abuses sought to be eliminated. An investment company is thus defined not only in terms of its purpose, but also in terms of an objective asset-based test, in part to minimize the possibility that an entity could inappropriately escape regulation under the Act. [32]

The SEC and its staff have construed the Investment Company Act's definition of "security" expansively, in order to carry out the Act's remedial purposes, even though the textual definition is virtually identical to that found in the other U.S. securities laws under which the definition has not been so broadly construed. [33] They have consistently taken the position that instruments such as

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commercial bank loans, loans to affiliates, certain instruments issued by insurance companies, commercial and other ordinary-course credit arrangements and the like, constitute securities under the Investment Company Act, although none of these items would qualify as securities under the other securities laws. [34]

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"Investment securities" includes all securities other than (i) "government securities"; [35] (ii) securities issued by employees' securities companies [36] and (iii) securities issued by entities that are (x) majority-owned subsidiaries of the entity being tested and (y) are not themselves investment companies or relying on the exceptions from the definition of "investment company" included in §§ 3(c)(1) or 3(c)(7) of the Investment Company Act. [37] As a result of that definition, securities issued by a sister or parent entity (*e.g.*, notes representing an intercompany financing) are treated as "investment securities" when the lender's status under the Investment Company Act is being considered, regardless of whether borrower and lender are under common control. If a security is issued by a majority-owned subsidiary of the entity being tested (*e.g.*, equity in a direct or indirect subsidiary held by a parent), that majority-owned subsidiary's status under the Investment Company Act must be tested to determine if the securities it has isssued are "investment securities," often requiring that the Investment Company Act tests be applied iteratively to each entity in a corporate chain.

The Investment Company Act prescribes the methods to be used when making determinations of value. Securities for which market quotations are available are valued at their market value as of the end of the last quarter. Securities for which market quotations are not readily available and all other assets owned at the end of the last quarter are valued at "fair value at the end of such quarter, as determined in good faith by the board of directors." [38] Assets acquired after the end of the last quarter are valued at cost.

The requirement to value many assets at fair value and the requirement that the determination of fair value be made by the board of directors often creates difficulty for companies. Although in transactions, such as some acquisition financings, where a third-party valuation of assets is obtained, the value ascribed to assets in that valuation is generally adopted by the board of the directors for purposes of this analysis, difficult questions are often raised in other contexts, particularly when the fair value of shares in subsidiaries must be determined and where there may be a significant gap between the carrying value of assets recorded under generally accepted accounting principles and fair value.

There is no doubt that conventional mutual funds are intended to be the primary subjects of Investment Company Act regulation. But the combination of the asset-based definition of investment company and the expansive interpretation of

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the definition of security potentially subjects other entities, known to commentators and practitioners as "inadvertent investment companies," to regulation under the Investment Company Act. The appropriateness of Investment Company Act regulation for these entities is far less obvious, but the Act nonetheless fully applies to them. These companies include holding companies that own controlling, but less than majority, interests in other companies, foreign banks and insurance companies and their holding companies, and finance subsidiaries whose assets consist of loans to their parents and affiliates. [39] The Investment Company Act and the rules thereunder contain a number of provisions excluding or exempting particular types of entities either from the definition of investment company or from the operation of the Act. [40] In addition, the Act grants authority to the SEC to exempt entities from specific provisions or from its provisions generally where such exemption is "necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions" of the Act. [41]

Investment Company Act regulation can even be relevant in the context of individual account management services. Prior to the adoption of Rule 3a-4 under the Investment Company Act, the SEC staff took the position that, where an adviser manages accounts using the same or similar investment strategies, the accounts could be aggregated pursuant to the staff's "integration" policy, [42] resulting in the creation of an investment company. This issue arises in the context of so-called "wrap-fee" programs. These programs, typically sponsored by a broker-dealer or investment adviser, provide advisory clients with access to third-party money managers that are selected by the broker-dealer or adviser. [43] Rule 3a-4 provides a nonexclusive safe harbor from regulation of these programs under the Investment Company Act, subject to reporting obligations and other conditions, including that (i) each client's account will be managed according to

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the financial situation and investment objectives and restrictions of the client, and (ii) each client retains the right, as though his or her securities and funds were not held in the program, to vote those securities and withdraw them or cash. [44]

Complex issues must also be considered in evaluating new financial products such as basket-, index- and equity-linked notes and warrants under an act that long antedated and did not ever contemplate their existence. Basket-linked notes or warrants involve the issuance of securities that are linked to a specific basket of stocks, whereas equity-linked notes or warrants pass through to investors returns on either a registered fund or, increasingly, a synthetic portfolio comprising a registered fund or fund-of-funds and specific fixed-income securities that are dynamically hedged based on an objective fixed formula.

Footnotes

30 §§ 3(a)(1)(A) and 3(a)(1)(C) of the Investment Company Act. There is also a third type of entity that falls within the definition of investment company—the "face amount certificate company" described in § 3(a)(1)(B) of the Investment Company Act—which is not relevant for the purposes of the discussion provided in this book.

31 As long as the trust has an investment purpose in acquiring the securities it holds and engages in no other business that may be considered "primary," that trust may be considered to be engaged primarily in the business of investing in the securities. *Credit Suisse First Boston Corporation* (avail. Sept. 9, 1998); *see also SEC v. Fifth Avenue Coach Lines, Inc.*, 289 F. Supp. 3, 30–31 (S.D.N.Y. 1968), *aff'd*, 435 F.2d 510 (2d Cir. 1970).

32 As stated by one observer, "[the SEC] conceived this objective [asset-based] standard, rejecting the descriptive approach theretofore advanced by text writers and others, because the existing definitions eliminated companies that exercised control or influence over their portfolio companies and because they contained indefinite terms." Edmund H. Kerr, *The Inadvertent Investment Company: Section 3(a)(3) of the Investment Company Act*, 12 STANFORD L. REV. 29, 33 (1959).

It is not clear how the objective asset-based test will be applied to investments in security futures products, which, unlike other securities, are essentially a type of notional contract that has no inherent value once marked-to-market.

33 Section 2(a)(36) of the Investment Company Act defines "security" as:

> any note, stock, treasury stock, security future, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security (including a certificate of deposit) or on any group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a "security", or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

See also § 12.01.

34 *See* § 12.01. The SEC and its staff's interpretations of the definition of "security" for purposes of the Investment Company Act are not, insofar as they are broader than those applied for purposes of the other U.S. securities laws, the subject of any published judicial or administrative decision.

The exclusions from the definitions of security under the Securities Act and the Exchange Act codified in the Commodity Futures Modernization Act of 2000 (the "CFMA"), Pub. L. No. 106-554, Appendix E, 114 Stat.

2763, 2763A–365 (2000), for qualifying swap agreements do not apply to the Investment Company Act. Title III of the CFMA contains a "savings clause" providing that nothing in the CFMA is to be construed as finding or implying that any swap agreement is or is not a security "for any purpose under the securities laws," including the Investment Company Act. § 304 of the CFMA. While interest rate and commodity swaps are unlikely to be considered securities for purposes of the Investment Company Act, the SEC staff has indicated in informal consultations that it would consider credit default swaps, which are linked or refer to defaults on specific securities or categories of securities of an issuer, to be securities for purposes of the Act. *See also MACRO Securities Depositor, LLC* (avail. Dec. 1, 2006) (granting no-action relief for trusts to enter into oil-linked OTC derivative instruments on a pre-determined formulaic basis and subject to certain other prescribed procedures, while noting that trusts using OTC derivative instruments linked to one or more securities or one or more securities indices may raise additional issues under the federal securities laws).

In 2007, the initial public offerings of several high-profile alternative asset managers, including Blackstone Group L.P. and Fortress Group LLC, attracted substantial attention, particularly with respect to their analysis of their holdings of investment securities. These entities hold principally general partnership and limited partnership interests in the private equity and hedge funds that they manage. Limited partnership interests count as securities for purposes of the Investment Company Act. General partnership interests, however, generally do not because they generate profits that result from the efforts of the general partner. Because of the high value attributed to their general partnership interests due to their entitlement to carried interest (*i.e.*, generally 20% of the profits realized by the underlying fund), investment securities comprised less than 40% of the total assets of these alternative asset managers, thereby exempting them from registration under the Investment Company Act at the time of their IPOs. *See* Andrew J. Donohue, Director, SEC Division of Investment Management, Testimony Concerning Initial Public Offerings of Investment Managers of Hedge and Private Equity Funds before the U.S. Senate Committee on Finance (July 11, 2007); *see also* Letter from Richard Trumka, AFL-CIO Secretary-Treasurer, to John White, Director, SEC Division of Corporation Finance, and Andrew Donohue, Director, SEC Division of Investment Management (May 15, 2007) (arguing that Blackstone should be viewed as an investment company because, among other things, the general partnership interests it holds are investment securities).

35 As defined in § 2(a)(16) of the Investment Company Act, "Government security" means any security issued or guaranteed as to principal or interest by the United States or its agencies or instrumentalities. Therefore, especially in the case of a foreign issuer, care should be taken to be sure that it has not categorized securities issued by a non-U.S. government as "Government securities" for this purpose.

An “employees' securities company” is an investment company all of the securities of which are owned by former and current employees of a single employer and certain other related parties.

36 § 2(a)(13) of the Investment Company Act.

37 § 3(a)(2) of the Investment Company Act.

38 § 2(a)(41) of the Investment Company Act.

39 Edmund H. Kerr, *The Inadvertent Investment Company: Section 3(a)(3) of the Investment Company Act*, 12 STANFORD L. REV. 29 (1959); Edmund H. Kerr & Alan Appelbaum, *Inadvertent Investment Companies—Ten Years After*, 25 BUS. LAW. 887 (Apr. 1970). Certain of these entities have been exempted or excluded by rule from regulation under the Act, as discussed in §§ 15.05 and 15.06. *See also Xplornet Communications Inc.* (avail. Jan. 11, 2012) (granting no-action relief under § 7(d) of the Investment Company Act to a Canadian broadband Internet service provider ("XCI"), where XCI may have been deemed an investment company if loans it made to a data transmission company were determined to be "securities.")

40 *See* §§ 15.05 and 15.06 for discussion of certain of the provisions.

41 § 6(c) of the Investment Company Act.

42 *See* § 15.06[3][c].

43 Wrap-fee arrangements also raise issues under the Advisers Act. The Advisers Act was amended to require that registered investment advisers that are sponsors of wrap-fee programs provide certain disclosure to prospective clients in these programs in addition to the brochure required under Rule 204-3 under the

Advisers Act. Mutual fund asset allocation programs are specifically excluded from the definition of wrap-fee programs for these purposes. *See* SEC Release No. IA-1411 (Apr. 19, 1994); § 16.05; *see also* §§ 15.03[2][b] and 15.06.

44 Rule 3a-4 under the Investment Company Act. The introductory note to Rule 3a-4 also clarifies that there is no registration requirement under § 5 of the Securities Act for programs organized to comply with the rule. For those programs that do not comply, prior SEC no-action letters continue to apply and impose substantially similar conditions. *See, e.g.*, *Wall Street Preferred Money Managers Inc.* (avail. Apr. 10, 1992) (stating that the staff would no longer respond to inquiries concerning when a discretionary adviser and its accounts are not subject to the Investment Company Act unless the request presented novel or unusual issues). Some have complained that Rule 3a-4 is being taken advantage of to allow Internet-based portfolio accounts and advisory accounts to operate as unregistered investment companies, and the Investment Company Institute (the "ICI") asked the SEC to consider regulating such accounts. *See* Paul F. Roye, Director, SEC Division of Investment Management, Remarks at the Third Annual IA Compliance Summit (Mar. 26, 2001).

U.S. Regulation of the International Securities and Derivatives Markets, § 15.03, REGISTRATION UNDER THE INVESTMENT COMPANY ACT

U.S. Regulation of the International Securities and Derivatives Markets
1 Edward F. Greene, Alan L. Beller, Edward J. Rosen, Leslie N. Silverman, Daniel A. Braverman, Sebastian R. Sperber, Nicolas Grabar & Adam E. Fleisher, U.S. Regulation of the International Securities and Derivatives Markets § 15.03 (11th and 12th Editions 2014-2017)
11th and 12th Editions

An investment company required to register with the SEC must operate as one of the three types of investment companies enumerated in the statute: a unit investment trust, a management company or a face amount certificate company. Management companies are in turn divided into open-end and closed-end companies. Unit investment trusts are defined as entities organized under trust indentures or similar instruments without boards of directors or similar bodies that issue only securities redeemable at any time at the option of the holder, each of which represents an undivided interest in a pool of specified securities. [45] Unit investment trusts are therefore generally fixed and unmanaged pools of assets. Face-amount certificate companies have been pushed out of the marketplace by other products; they are now extremely rare [46] and will not be considered further in our discussion. Management companies comprise all other investment companies. Open-end companies, the entities commonly referred to as "mutual funds" in the U.S. market, are defined as those having securities outstanding that are redeemable at any time at the option of the holder. [47] Closed-end companies, which do not issue securities redeemable by the holder at will and are traded in the secondary market, include all other management companies. [48] The requirements applicable to a registered investment company depend in part on its type. [49]

Although the system of classification contained in the Investment Company Act might have been an accurate reflection of the types of investment companies that were in existence when the Investment Company Act was adopted over 70 years ago, requiring an investment company to fit into one of these classifications now may be inconsistent with legitimate business objectives. One of the most popular investment vehicles introduced in recent years is the exchange-traded fund or "ETF." ETFs are a hybrid of open-end and closed-end funds—they are traded on the secondary market like shares of stock and their shares are redeemable, although only in very large blocks, which provides certain efficiencies in the operation of the funds. Because the innovative structure of ETFs was not contemplated by the drafters of the Investment Company Act, they do not fit neatly within the typology prescribed by the Act and, to date, have been able to operate only under individually granted exemptive orders from the SEC. [50] Historically, only "index" ETFs, which are designed to mirror the performance of certain public market indices, were available in the United States; however, in 2008, the SEC began to issue exemptive orders involving actively managed ETFs. [51] Recognizing the increasing popularity of ETFs, the SEC also proposed new rules that would codify much of the exemptive relief granted in the ETF

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area, including in respect of actively managed ETFs, [52] although to date it has only adopted rules addressing ETF disclosure and prospectus requirements. [53]

A registered investment company is subject to very significant ongoing disclosure [54] and regulatory requirements. Although disclosure to investors and potential investors is an important part of the Investment Company Act's scheme, its primary focus is on substantive regulation, including:

- the composition of the board of directors;
- transactions between an investment company and its promoters, underwriters, advisers and other affiliated persons;

- issuance of debt or other "senior" securities and other borrowings to create leverage;
- investment in other investment companies;
- securities custody arrangements; and
- prices at which redeemable securities may be offered or redeemed.

This detailed substantive regulation derives from Congressional intent to curb specific types of abuses. For example, because fund managers of the 1930s "refused to recognize their fiduciary obligations to the shareholders" and engaged in transactions that victimized investors while benefiting themselves, [55] the Investment Company Act includes very restrictive provisions regarding related party transactions. Similarly, the provisions restricting ownership by one investment company of securities of another derive directly from "fund of funds" abuses, involving fees and self-dealing to the benefit of advisers and promoters but to the detriment of investors. [56] Although these and other detailed regulatory provisions have laudable origins, many exceed, and in some cases are inconsistent with, requirements applicable to foreign investment companies in their local jurisdictions. In the case of foreign companies that are inadvertent investment

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companies, it is fair to say that such regulation is unheard of outside the United States.

Footnotes

45 § 4(a)(2) of the Investment Company Act.

46 According to one industry participant, as of 1990, there were only two active face-amount certificate companies in the United States. *See* Letter of IDS Financial Services Inc. (Oct. 2, 1990).

47 § 5(a)(1) of the Investment Company Act.

48 § 5(a)(2) of the Investment Company Act.

49 In addition, investment companies making public offerings in the United States are required to register such offerings under the Securities Act. *See* Chapter 3 and § 15.08. Public investment companies are also subject to many of the disclosure obligations applicable to public companies generally, as well as to many of the "buy side" pressures on disclosure and operational matters faced by public companies, including for example in the area of corporate governance. *See, e.g.*, ICI, *ENHANCING A CULTURE OF INDEPENDENCE AND EFFECTIVENESS*, Report of the Advisory Group on Best Practices for Fund Directors (June 24, 1999).

50 *See, e.g.*, *Foreign Fund Inc.*, SEC Release Nos. IC-21737 (Feb. 6, 1996) (notice) and IC-21803 (Mar. 5, 1996) (Order).

51 *See, e.g.*, *Wisdom Tree Trust*, SEC Release Nos. IC-28147 (Feb. 6, 2008) (notice of application) and IC-28174 (Feb. 27, 2008) (Order); *Barclays Global Fund Advisors*, SEC Release Nos. IC-28146 (Feb. 6, 2008) (notice of application) and IC-28173 (Feb. 27, 2008) (Order); *Bear Stearns Asset Management, Inc.*, SEC Release Nos. IC-28143 (Feb. 5, 2008) (notice of application) and IC-28172 (Feb. 27, 2008) (Order); and *Power-Shares Capital Management LLC*, SEC Release Nos. IC-28140 (Feb. 1, 2008) (notice of application) and IC-28171 (Feb. 27, 2008) (Order).

52 SEC Release No. IC-28193 (Mar. 11, 2008) (proposing new Rules 6c-11 and 12d1-4 and amendments to Rule 12d1-2 and Form N-1A under the Investment Company Act).

53 SEC Release No. IC-28584 (Jan. 26, 2009) (amending Form N-1A); *see also* SEC Release No. IC-32315 (Oct. 13, 2016).

54 *See, e.g.*, SEC Release No. IC-32314 (Oct. 13, 2016).

55 86 CONG. REC. 2844 (1940).

56 The "anti-pyramiding" provisions, which addressed abuses identified by Congress in 1970, *see* Investment Company Amendments Act of 1970, Pub. L. No. 91-547, § 7, 84 Stat. 1413, 1418–1421 (1970), have since been relaxed by the NSMIA to permit "fund of fund" structures in which a fund acquires shares in other

funds to provide certain asset allocation options to investors. The SEC has also adopted rules that to a certain extent further expand the circumstances in which a fund may invest in shares of another investment company. SEC Release No. IC-27399 (June 20, 2006).

U.S. Regulation of the International Securities and Derivatives Markets, § 15.04, JURISDICTION OVER FOREIGN INVESTMENT COMPANIES

U.S. Regulation of the International Securities and Derivatives Markets
1 Edward F. Greene, Alan L. Beller, Edward J. Rosen, Leslie N. Silverman, Daniel A. Braverman, Sebastian R. Sperber, Nicolas Grabar & Adam E. Fleisher, U.S. Regulation of the International Securities and Derivatives Markets § 15.04 (11th and 12th Editions 2014-2017)
11th and 12th Editions

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The Investment Company Act regulates foreign investment companies by restricting their offerings of securities in the United States. A foreign investment company is prohibited under the Investment Company Act from making a public offering in the United States unless it has received an order from the SEC permitting it to register as an investment company, and those orders generally impose conditions that parallel the provisions of the Investment Company Act. [57] The requirements that must be met to obtain such an order are such that, as discussed in § 15.08, with the exception of a few Canadian investment companies, U.S. public offerings by foreign investment companies are effectively prohibited. Although the Investment Company Act does not explicitly address private offerings by foreign investment companies, the SEC also has placed substantial limitations on such offerings based on the rules applicable to U.S. private investment companies, as discussed in § 15.06.

Footnotes

57 § 7(d) of the Investment Company Act and Rule 7d-1 thereunder.

U.S. Regulation of the International Securities and Derivatives Markets, § 15.05, EXCLUSIONS AND EXEMPTIVE RELIEF

U.S. Regulation of the International Securities and Derivatives Markets
1 Edward F. Greene, Alan L. Beller, Edward J. Rosen, Leslie N. Silverman, Daniel A. Braverman, Sebastian R. Sperber, Nicolas Grabar & Adam E. Fleisher, U.S. Regulation of the International Securities and Derivatives Markets § 15.05 (11th and 12th Editions 2014-2017)
11th and 12th Editions

As discussed above, the definition of "investment company" has posed special problems for foreign entities that may fall within the definition—as interpreted by the SEC—but that would not ordinarily be considered investment companies within the common sense meaning of the term. A company falling within the definition of investment company may seek special exemptive relief from the SEC from all or certain provisions pursuant to § 6(c) of the Investment Company Act. The exemptive process, discussed in § 15.05[7], is uncertain and generally protracted and expensive. In recent years, the SEC staff has been reluctant to grant exemptive orders containing any novel elements, and even when granted, it has taken inordinate amounts of time to obtain such orders. Seeking such orders is therefore often unattractive for foreign companies seeking exemption from the Investment Company Act. Where the SEC has developed a consistent view in the context of successive § 6(c) applications presenting similar issues, the SEC has, through its rule-making power, excluded foreign finance subsidiaries, as well as foreign banks and insurance companies and their holding companies, and certain other companies from the definition of investment company, despite their asset composition.

[1] Finance Subsidiaries—Rule 3a-5

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The SEC has excluded certain finance subsidiaries from the Act's definition of investment company in Rule 3a-5 under the Investment Company Act. [58] The rule is applicable to finance subsidiaries organized within or outside the United States, and to those of both U.S. and foreign issuers. Rule 3a-5 provides that such a subsidiary will not be considered an investment company and that the securities of the subsidiary held by its parent [59] or a company controlled by the parent [60] will not be "investment securities" if the conditions of the rule are satisfied. The rule requires that the parent company own all of the securities (except

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for debt securities and nonvoting preferred shares) of the finance company, although the staff has granted no-action relief for a structure in which the parent company effectively controlled, but did not actually own, the securities of the finance subsidiary. [61] Among its other requirements, Rule 3a-5 specifies that payment of any publicly offered or publicly held nonvoting preferred stock and debt securities [62] of the finance subsidiary must be unconditionally guaranteed by its parent. [63] For these purposes, a "keepwell" or support agreement between the parent and the subsidiary, providing, for example, that the parent will assure that the

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issuing subsidiary has sufficient resources to satisfy its obligations, is not sufficient. [64] Where the parent company is a foreign bank, [65] however, 1991 amendments to Rule 3a-5 [66] permit the parent to issue an irrevocable letter of credit in favor of security holders in lieu of a guaranty, provided that payment on the letter of credit is conditioned only upon presentation of "customary documentation" and beneficiaries may proceed to enforce the letter of credit directly against the parent. [67] Any convertible or exchangeable securities issued by the finance subsidiary must be convertible solely into or exchangeable solely for the parent's securities or other debt or nonvoting preferred stock of the subsidiary that meets the guarantee and other requirements of Rule 3a-5 under the Investment Company Act. [68]

Rule 3a-5 also places limitations on the use of proceeds received as a result of the finance subsidiary's offering. At least 85% of such proceeds in the form of cash or cash equivalents must be invested in or loaned to its parent or a company controlled by the parent within six months of receipt. [69] In addition, the finance

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subsidiary may not trade or own any securities other than U.S. government securities, commercial paper meeting the requirements of § 3(a)(3) of the Securities Act [70] and securities of its parent or companies controlled by its parent. [71] The restrictions on the types of securities in which the finance subsidiary may invest are apparently intended to assure that the finance subsidiary does not present risks that would make its regulation as an investment company appropriate. The restriction nevertheless can raise significant issues, particularly in the case of non-U.S. entities whose investments properly include other obligations, such as government securities issued by their "host" government. The impediment to rational financing strategies that Rule 3a-5 presents in this context often prevents issuers from taking advantage of the rule's exemption, and its various limitations should be reconsidered by the SEC.

Finally, the parent company providing the guarantee and any affiliated company to which the proceeds are loaned may not be an investment company or must be exempted under § 3(a) or (b) of the Investment Company Act or one of the SEC's rules under those sections, [72] although the SEC has provided exemptive relief to parent companies that are excluded from the definition of "investment company" under § 3(c)(3), [73] § 3(c)(5)(A), § 3(c)(5)(B) [74] or

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§ 3(c)(6) [75] but that otherwise satisfy the requirements of Rule 3a-5. [76] Because Rule 3a-6 under the Investment Company Act excludes foreign insurance companies and banks (including government-owned institutions that qualify as "foreign banks" under the rule) [77] from the definition of "investment company," finance subsidiaries of these entities may now rely on Rule 3a-5 if they satisfy the rule's other conditions.

Because the parent guarantee requirement of Rule 3a-5 is applicable only in the case of finance subsidiaries that have outstanding debt securities and nonconvertible preferred stock that were "issued to or held by the public," the rule is available—without the need for a parent guarantee—to finance subsidiaries whose debt and preferred stock are issued in private placements, [78] including private placements contemplating the possibility of resales under Rule 144A under the Securities Act. [79]

The SEC staff has also taken the position that the phrase "issued to or held by the public," as used in Rule 3a-5, does not encompass an offering undertaken pursuant to Regulation S under the Securities Act. [80] Securities of a finance company so offered need not be guaranteed by the company's parent to comply with Rule 3a-5 under the Investment Company Act.

[2] Foreign Banks and Insurance Companies—Rule 3a-6

Rule 3a-6 under the Investment Company Act excludes banking institutions and insurance companies organized outside the United States from the definition of "investment company," exempting them entirely from the operation of the Investment Company Act, if they are regulated by home country authorities

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as a banking institution or insurance company, as applicable, and either engaged substantially in commercial banking activity [81] or engaged primarily and predominantly in writing insurance contracts [82] or the reinsurance of such insurance contracts underwritten by insurance companies, as applicable. [83] Rule 3a-6 replaced and broadened Rule 6c-9, [84] which provided a more limited exemption available only to foreign banks and their finance subsidiaries in the case of certain offerings of debt securities and nonvoting preferred stock. [85] Issuers seeking to rely on Rule 3a-6 in connection with a U.S. public offering registered under the Securities Act must file with the SEC a brief form (Form F-N) that identifies the issuer and its agent for purposes of receiving service of process in the United States. [86]

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Because Rule 3a-6 excludes foreign banks and insurance companies from the definition of "investment company" rather than merely exempting them from the requirements of the Investment Company Act, such entities (and their holding companies and finance subsidiaries) can take advantage of other exemptive provisions that depend on their status as noninvestment companies. [87] For example, the restriction on the holding of the securities of investment companies by registered investment companies does not apply to their holdings of securities of foreign banks and insurance companies because they are excluded from the definition of "investment company" (and not merely exempted from the operation of the Investment Company Act). [88]

Common or collective trusts, separate accounts or other pools of assets in which interests are offered (as opposed to direct interests in the issuer) will not qualify as foreign banks or insurance companies under the rule. [89] Additionally, Rule 3a-6 does not address the situation of a number of foreign bank-like entities that have sought to make offerings in the United States but, because of the nature of their assets, have sought assurances that they are not subject to regulation under the Investment Company Act. [90] Certain special credit institutions have received exemptive relief, including a non-governmental issuer of covered bonds backed by public sector debt and mortgage obligations that was not permitted to take deposits and was therefore not a "bank" for purposes of Rule 3a-6. [91] Nevertheless, relief was granted on the basis of the regulatory and supervisory home-country regime and the restricted nature of the issuer's activities.

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Government-owned and controlled non-bank credit institutions also generally fall outside the scope of Rule 3a-6. These foreign institutions are most often involved in using their funds, which they obtain from the governments that control them and from borrowings from banks and in the capital markets, to make loans to finance economic development, export or import transactions or other activities that are part of government policy. Their assets, however, are predominantly loan receivables that may be viewed as securities under the Investment Company Act.

If these entities are not regulated as banks or "substantially engaged in commercial banking activity," they are not able to rely on Rule 3a-6 (nor would their finance subsidiaries be able to rely on Rule 3a-5 under the Investment Company Act), notwithstanding that they are generally referred to as "banks." It would appear sound, both as a matter of policy and interpretation of the Investment Company Act in light of the provisions of the Securities Act, that an issuer filing a registration statement under Schedule B of the latter as a "foreign government or political subdivision thereof" should not be viewed as an investment company. However, the SEC appears to have taken the position that, while it may be inclined to be more flexible in avoiding application of the Investment Company Act in such cases, Schedule B status is not in itself grounds for doing so. Export-import banks have generally obtained no-action relief confirming that they may rely on the exemption for companies principally engaged in purchasing and financing receivables, discussed at § 15.05[3], on the grounds that their activities generally involve lending money for, or purchasing or otherwise refinancing, purchases of goods or services in connection with import or export transactions. [92] The SEC has granted exemptions from all provisions of the Investment Company Act under § 6(c) to development banks and other government-related financing institutions where the exemptions for specific kinds of financing activity cannot be relied on. [93] The SEC has relied on the

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strong elements of foreign government policy and foreign government control behind the activities of these entities in granting these exemptions. In other cases, where application for no-action or exemptive relief under the Investment Company Act has not been made, the SEC has apparently not raised the question of whether Investment Company Act registration is required and has declared effective under the Securities Act registration statements for governmental entities such as development banks that have filed under Schedule B.

[3] Asset-Backed Arrangements

[a] Companies "Primarily Engaged" in Purchasing Mortgages and Receivables—§ 3(c)(5)

As a result of negotiations at the time the Investment Company Act was adopted, exclusions from the operation of the Act were provided for finance and similar companies that were not banks but that purchased and financed mortgages and receivables for goods and services. [94] This exclusion, in addition to being relied on by such companies, was, at least until the adoption in 1992 of Rule 3a-7 under the Investment Company Act, the principal provision relied on to keep many asset-backed arrangements from having to register under the Investment Company Act (for purposes of this chapter, asset-backed arrangements are referred to as "ABAs"). In particular, the issuers of mortgage-backed securities and of many receivables-backed securities, whether organized within or outside the United States, have been able to fit within these exclusions. [95] These provisions have also been the basis for conclusions that certain foreign issuers, particularly government-related entities, whose business is the financing of the purchase of specified merchandise and services (such as special purpose entities designed to refinance military equipment sales) are not investment

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companies. [96] In cases of close questions regarding these provisions, the SEC appears disposed to grant exemptive orders under § 6(c) of the Investment Company Act rather than interpret the exemptive provisions themselves to permit the proposed activities in order to maintain the ability to impose additional conditions on a particular exemption's availability.

These provisions raise a number of interpretive questions, and, on some, SEC guidance has been received. The question of what is required to be "primarily engaged" has been considered extensively in the case of mortgage-backed ABAs. In some cases, only a portion of the assets of an issuer consists of "whole loans" secured by mortgages, which are considered by the SEC to be "mortgages and other liens on and interests in real estate," [97] while the remainder consists substantially of participations or other partial interests in such loans, which, in the view of the SEC, are not "mortgages and other liens on and other interests in real estate." The SEC has granted no-action relief where pools of assets contain at least 55% by value of whole loans, finding that such pools satisfy the "primarily engaged" test. [98] The SEC has undertaken a review of market practice and its guidance under § 3(c)(5)(C), requesting comment on whether such arrangements should be prohibited from relying on § 3(c)(5) and limited—by statute or rule—to reliance on Rule 3a-7 only (discussed below). [99]

There have also been a number of interpretations regarding the types of activities that constitute the purchase of receivables and the sorts of assets that constitute permissible receivables within § 3(c)(5) of the Investment Company Act. [100] For example, relief has been granted where the purchased receivables consisted of intellectual property royalty payments where such payments were directly based on the sales price of the products using the intellectual property in

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question. [101] In another instance, no-action relief was granted to a non-governmental issuer of covered bonds that made loans to public sector entities for construction and renovation projects, based in part on the analysis that the loans were to prospective purchasers of specified merchandise and services within the meaning of § 3(c)(5)(B). [102] In some credit card receivables securitization transactions involving ABAs and relying on § 3(c)(5), transaction participants have agreed to place restrictions on the use of such receivables resulting from cash advances, as opposed to receivables resulting from the purchase of goods and services, on the theory that only the latter receivables fall within the categories enumerated in § 3(c)(5). [103]

[b] Other Asset-Backed Arrangements—Rule 3a-7

Largely in response to comments that it received in response to the Concept Release, [104] the staff adopted Rule 3a-7 under the Investment Company Act to exclude from the definition of "investment company" issuers that do not issue redeemable securities [105] and that pool receivables, the cash flow on which is the principal source of funds for payment of the securities of those issuers. [106] Rule

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3a-7 is available for pools of "eligible assets," which are defined as "financial assets, either fixed or revolving, that by their terms convert into cash within a finite time period plus any rights or other assets designed to assure servicing or timely distribution of proceeds to security holders." [107] The definition is intended to include credit and liquidity facilities "designed to assure the servicing or timely distribution of proceeds to security holders." [108]

To qualify for the Rule 3a-7 exemption, an issuer may only issue "fixed income securities" [109] or other securities that entitle their holders to receive payments that depend "primarily" on the cash flow from eligible assets. [110] The payment of residual interests out of proceeds from the sale or other disposition of underlying assets will therefore not prevent reliance on the exemption. Only fixed-income securities that are rated at the time of initial sale in one of the four highest rating categories applicable to long-term debt (or an equivalent short-term category depending on the maturity of the securities)—that is, are rated "investment grade"—by at least one nationally recognized statistical rating organization, may be sold publicly by the issuer or its underwriters without any

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restriction. [111] While the SEC has proposed removing reliance on credit ratings from certain rules, [112] the SEC has requested comment on whether this and other references to credit ratings in Rule 3a-7 should be retained, or whether references to credit ratings should be replaced with conditions that are tailored to address Investment Company Act and related concerns. [113] In contrast, noninvestment grade fixed income securities may be sold only to institutional "accredited investors" within the meaning of Rule 501(a)(1), (2), (3) or (7) under the Securities Act, and to other institutions all of the equity of which is owned exclusively by such investors. All other securities, including residual interests, may be sold only to "qualified institutional buyers" within the meaning of Rule 144A under the Securities Act [114] and to persons who are involved in the organization or operation of the issuer and their affiliates. [115] Issuers and underwriters must exercise reasonable care, including through the use of legends and contractual restrictions, [116] to ensure that nonconforming securities (*i.e.*, securities that do not qualify as "fixed-income securities" or meet the rating condition) are sold or resold solely to the applicable types of institutional investors. [117] The SEC staff has orally confirmed, and transactions have proceeded on the understanding, that

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investors in offerings by non-U.S. issuers under Rule 3a-7 that are not U.S. persons (generally following the definition set forth in Regulation S under the Securities Act) and that purchase these unrated or lower-rated securities (either in a primary offering or in the secondary market) need not meet the requirement that they be qualified institutional buyers or institutional accredited investors. But the SEC staff has provided no formal guidance as to whether U.S. persons acquiring such securities from non-U.S. persons in the secondary market must meet this requirement. [118]

Dispositions and acquisitions of eligible assets during the term of the securities are permitted as long as these actions (i) are authorized in the documents governing the financing, (ii) do not result in a downgrade of outstanding fixed-income securities of the issuer and (iii) are not undertaken for purposes of recognizing gains or preventing losses resulting from volatility in the market value of eligible assets. [119]

Finally, Rule 3a-7 requires, other than in the case of asset-backed commercial paper programs, that the issuer appoint a trustee for the pool and that the trustee be unaffiliated with the issuer or any person involved in the organization or operation of the issuer. [120] The SEC has, however, permitted as trustee a disclosed affiliate of an underwriter of the issuer's securities. [121] The rule, nevertheless, permits a trustee to act as servicer if the primary servicer becomes unable to act as such, but prohibits a trustee from providing any credit enhancement for the securities. [122] A trustee must agree that it will not resign until the financing is liquidated or a successor trustee is appointed. [123] The issuer must take reasonable steps to ensure that the trustee has "a perfected security interest or ownership interest valid against third parties" in the assets of the issuers that "principally" [124] provide the cash flow to make payments of the securities. Under the standard imposed by the rule, a trustee need not therefore have a *first* priority perfected security interest. [125]

The adoption of Rule 3a-7 has facilitated offerings in the U.S. public markets of a variety of ABAs that prior thereto were restricted or effectively prohibited. Among these instruments are nonredeemable securities representing an interest in a pool of debt securities created in a repackaging strategy or securities backed by receivables, loans or other debt instruments that do not qualify for exemption under § 3(c)(5) of the Investment Company Act. Rule 3a-7 has also facilitated U.S. public offerings of structured products consisting of interests in a combination of one or more of such instruments combined with, for example, a currency or interest-rate swap. [126] In recent years, the SEC staff has indicated a growing antipathy to the uses of Rule 3a-7 and has been construing the provisions of the rule increasingly strictly, with the result that novel ABA structures may have difficulty qualifying under the rule.

[4] Rules 3a-1 and 3a-3

Rule 3a-1 under the Investment Company Act somewhat limits the impact of § 3(a)(1)(C) of the Investment Company Act in the case of certain inadvertent investment companies having more than 40% of their assets invested in investment securities.

Under Rule 3a-1, an issuer will not be considered an investment company if (i) no more than 45% of the value of such issuer's total assets (exclusive of U.S. government securities, cash items, securities of majority owned subsidiaries and securities of companies "controlled primarily" by the issuer and through which it engages in non-investment company businesses) [127] consists of, and (ii) no more than 45% of such issuer's net income after taxes for the last four

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fiscal quarters is derived from, investment securities. Rule 3a-1 requires that "wholly-owned subsidiaries," subsidiaries in which the issuer owns 95% or more of the voting securities, be consolidated for purposes of its asset and income tests.

Regarding the exclusion of securities issued by companies "controlled primarily" by the issuer, as described above, while the Investment Company Act provides a definition of "control," [128] which is presumed to exist when a person owns more than 25% of the voting securities of an issuer, neither the Act nor the rules thereunder define the term "controlled primarily." In proposing Rule 3a-1, the SEC stated that the "controlled primarily" standard was designed to limit the effect of subsection (a)(4)(i) of the rule to those companies that are controlled to the same extent as a majority-owned subsidiary is controlled. [129] Where an entity owns 25% to 50% of a company's shares, but there is another potential control block, the facts and circumstances of the relationship of the parties must be considered. [130]

The excluded securities must also be issued by a company "through which" the issuer engages in a business other than that of an investment company. [131] This requires that the issuer exercise active control over the company in question. [132] In the absence of facts evidencing close involvement with the company, an issuer may have difficulty demonstrating that it is acting "through" the company.

The final element of Rule 3a-1 requires that the issuer not be a "special situation investment company." [133] A special situation investment company is a company that secures control of other companies primarily for the purpose of making a profit in the sale of their securities, as opposed to a holding company that secures control of other companies primarily for the purpose of engaging in those companies' lines of business. [134]

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Rule 3a-3 under the Investment Company Act builds on Rule 3a-1 by exempting from the registration requirements of the Act any issuer all of whose securities (other than short-term paper and certain other limited classes of securities) are owned, directly or indirectly, by a company that meets the asset and income tests of

Rule 3a-1 and that either is not an investment company as defined in § 3(a) [135] or is excluded from the definition by specified provisions. A principal benefit of Rule 3a-3 for foreign companies has been to provide an exemption for finance companies that are wholly owned by their parent, have no long-term debt to third parties and issue only short-term instruments (*e.g.*, commercial paper) without requiring such issuers to meet all of the additional conditions of Rule 3a-5 under the Investment Company Act. [136]

[5] Transient Investment Companies—Rule 3a-2

Companies that would otherwise come within the definition of investment company under § 3(a)(1) of the Investment Company Act may be able to avoid being subject to the Act for up to one year under Rule 3a-2. [137] Rule 3a-2, which codifies a line of no-action letters issued by the staff, requires such a company to have a *bona fide* intent to be engaged primarily in a business other than investing, reinvesting, owning, holding or trading of securities as soon as reasonably possible, and at most within a year. [138] A company seeking to rely on Rule 3a-2 must evidence such intent by both its business activities and an appropriate resolution of the company's board of directors. [139] This rule can be particularly useful in certain situations, such as for a start-up company with substantial assets temporarily in investment securities pending the purchase of operating assets or the consummation of planned acquisitions, [140] or alternatively, for a company that

holds a valuable minority interest in another enterprise acquired, for example, as part of a planned, but ultimately abandoned, acquisition.

Rule 3a-2 may not be used by a company that holds itself out as being in the business of investing or trading securities. [141] Also, a company may not rely on Rule 3a-2 more than once in any three-year period. [142]

[6] Research and Development Companies—Rule 3a-8

Certain research and development companies that would otherwise come within the definition of investment company under § 3(a) are, as a result of the adoption by the SEC of Rule 3a-8, exempt from the Act. [143] Research and development companies tend to come within the definition of investment company for two reasons: first, they seldom have substantial tangible assets and often raise large amounts of capital, invest the proceeds and use the return on those investments to fund their operations; and second, as part of a strategic alliance to conduct research and develop products, they may purchase a noncontrolling equity stake in another company. [144]

To qualify for the safe harbor provided by Rule 3a-8, a research and development company must satisfy four principal [145] criteria: first, a company's

research and development expenses, for its last four fiscal quarters combined, must constitute a "substantial percentage" of its total expenses over the same period; second, a company's net income derived from investments in securities, for its last four quarters combined, may not exceed twice the amount of its research and development expenses for the same period; third, a company may devote no more than five percent of its total expenses for its last four fiscal quarters combined to investment advisory, management and related activities; and fourth, with two exceptions, a company's investments in securities must constitute "capital preservation investments." [146]

[7] SEC Exemptive Power

[a] Section 6(c)

The detailed regulatory provisions of the Investment Company Act are coupled in many cases with a grant of exemptive power to the SEC. [147] In addition, § 6(c) of the Investment Company Act [148] grants the SEC, subject to satisfaction of the statutory standard, broad exemptive authority with respect to any or all of the provisions of the Investment Company Act. In order for relief to be

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granted under § 6(c), an applicant bears the burden of showing that the relief requested is "necessary or appropriate in the public interest" *and* "consistent with the protection of investors and the purposes fairly intended by the policy and provisions" of the Investment Company Act. [149] The SEC's authority under § 6(c) is permissive rather than mandatory: the SEC "may" grant an exemption upon a finding satisfying the statutory standard. Nevertheless, if the required finding is made, the SEC's power under § 6(c) appears to be very broad. [150] The inclusion of § 6(c) was the result of the recognition by the drafters of the Investment Company Act that its provisions could prove too specific to accommodate innovation in the investment fund industry. [151] The SEC thus has the express authority to exempt persons, transactions and securities from the operation of any provision of the Investment Company Act or any rule or regulation thereunder, as well as to grant relief on an unconditional basis or subject to whatever conditions it

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deems appropriate to ensure compliance with the terms of the relief, to protect investors or otherwise to implement the intent of the Investment Company Act in the circumstances of the relief granted.

Foreign companies have used the § 6(c) exemptive process both to gain relief with respect to specific provisions of the Investment Company Act and to obtain exemption from the entire Investment Company Act. [152] As an example of the former, in the few cases in which foreign funds have been permitted to register under § 7(d) of the Investment Company Act for purposes of making a public offering in the United States, an SEC order under § 6(c) has sometimes been necessary to address differences between the Investment Company Act and foreign regulations. As an example of the latter, a very large number of foreign banks obtained exemptions from the Investment Company Act under § 6(c) to issue debt securities in the United States prior to the adoption of the predecessor to Rule 3a-6 discussed in § 15.05[2].

Both U.S. and foreign companies have also received § 6(c) exemptive orders in situations where foreign laws or other considerations prevent the companies from acquiring majority interests or control over foreign ventures, thereby increasing the risk that these interests would qualify as "investment securities" under the Investment Company Act and that the companies would be classified as investment companies. [153] In order to obtain the exemptive relief, however, a company must take an active role in the development of the foreign ventures, and not merely be a passive investor. [154]

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The application for exemptive relief must describe the relief sought, as well as an "adequate basis" for requesting the relief. [155] The SEC also encourages applicants to provide detail with respect to SEC precedents that may be relevant to a determination of an exemptive request. After receiving an application, [156] the SEC will publish in the *Federal Register* for public comment a notice of the application containing the names of the parties involved and a brief description of the proposed transaction or circumstances prompting the application, the basis for relief and the key representations and undertakings contained in the application. In response to the notice, interested parties may submit comments to the SEC concerning the application or may request a public hearing to present their views.

According to internal guidelines of the SEC's Division of Investment Management, the division responsible for administration of the Investment Company Act, the SEC aims to provide initial comments on an exemptive application within 45 days of receipt (although the guidelines clarify that complex or novel issues may require a longer period of review), and notices of routine requests are to be published for comment within 60 days of receipt of the application. In recent years, however, the staff has often had difficulty in adhering to these guidelines and has evidenced a general reluctance to exercise its exemptive authority, with the result that requests for exemptive orders have remained pending for extended periods. In the case of requests raising new issues, one or more rounds of staff comments requiring the preparation and filing of a revised formal application are common and add significantly to the time required to obtain relief. Publication of the notice occurs generally only after the SEC is satisfied with the application, and the notice period generally extends for 25 to 28 days. [157] The guidelines also require that SEC orders granting exemptive requests be published within two business days after the expiration of the notice period, if no hearing request is filed. In general, because all issues have been settled with the staff between the first filing of the request for exemption and publication of notice, this last very short deadline is not only difficult for the SEC to meet, but

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also is not particularly relevant in a consideration of the overall length of the process.

The § 6(c) process has significant shortcomings. First, because the relief is exemptive, each applicant seeking an exemption, even if it is identical to one already granted, must proceed separately. As a result, although the SEC often processes applications for repeat relief expeditiously, a minimum of four to six weeks is likely to be necessary. Second, for other exemptive requests in which something more is sought than relief identical to that previously granted to another applicant, the time and expense involved can increase significantly. Conducted as described above, with publication of the application and opportunity for interested parties to object to the requested relief through a hearing process, obtaining an exemption can, under the best of circumstances, take a number of months and applications containing novel elements have sometimes remained pending for several years. The exemptive process under § 6(c) may also create a disincentive to pioneer new investment products because, although the first application for relief may require significant time and expense, subsequent applications by others requesting identical relief are processed more quickly and involve considerably less expense for the applicants. Commenters responding to the Concept Release urged that the SEC take action to reduce the time and expense associated with exemptive relief under § 6(c). At least one commenter suggested that the SEC make broader use of its ability to exempt classes of securities or transactions under § 6(c) under the Investment Company Act. [158]

The SEC acknowledged the inefficiency of the current exemptive process in the 1992 Report and proposed amendments to Rule 0-5 under the Investment Company Act to permit the staff to address on an expedited basis exemptive applications for which there is precedent and amendments to Rule 30-5 of the SEC's Rules of Practice that would increase the number of provisions of the Investment Company Act as to which the Division of Investment Management would be authorized by the SEC to take action pursuant to delegated authority. [159] The SEC adopted the changes to Rule 30-5 of its Rules of Practice in 1995, [160] but it has not taken action on the proposed changes to Rule 0-5 under the Investment Company Act. [161]

[b] Section 3(b)(2)

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During the height of the "Internet boom" in 1999 and 2000, a number of "Internet incubator" and other "new economy" companies availed themselves of the staff's exemptive power under § 3(b)(2) of the Investment Company Act, [162] which excepts from the definition of "investment company" those companies that the SEC declares to be "primarily engaged" in a business other than investing, reinvesting, owning or holding securities. Some of these companies had significant, but not "controlling," interests [163] in other Internet-related companies, and when the market value of these holdings increased very rapidly, the companies were unable to avoid tripping the 40% test in the definition of investment company under § 3(a)(1)(C) of the Act. For example, both Yahoo! Inc. and Bill Gross's idealab! had "strategic holdings" that were considered "investment securities" under § 3(a)(1)(C) of the Investment Company Act. Both of these companies were, however, successful in obtaining exemptive relief under § 3(b)(2) of the Investment Company Act. [164] More recently, a company that was a member of a joint venture outside the technology sector was able to obtain exemptive relief where, despite owning 50% of the outstanding voting securities, it was only entitled to elect a minority of the board of directors but retained significant veto rights over board and shareholder actions by virtue of supermajority voting requirements and active participation in the management and affairs of the joint venture company. [165]

In considering applications for exemptive relief under § 3(b)(2), the SEC has stated that it considers:

- the company's historical development;
- the company's public representations of policy;
- the activities of the company's officers and directors;
- the nature of the company's present assets; and
- the source of the company's present income.

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The determination of whether a company has qualified for exemption is based on all of the relevant facts and circumstances. [166] Like other exemptive relief under the Investment Company Act, obtaining relief under § 3(b)(2) can be expensive and time consuming. But for companies like Yahoo! or Bill Gross's idealab!, which are dependent on access to U.S. capital markets, there may be no alternative.

Certain foreign companies have used similar Internet-related business models and have faced similar issues under the Investment Company Act. But the very substantial time and cost required to obtain such exemptive relief have usually dissuaded potential foreign issuers from doing so.

Footnotes

58 Rule 3a-5(b) under the Investment Company Act defines "finance subsidiary" as any corporation:

> (i) All of whose securities other than debt securities or non-voting preferred stock meeting the applicable requirements of paragraphs (a)(1) through (a)(3) [relating to the parent company's guarantee of such securities] or directors' qualifying shares are owned by its parent company or a company controlled by its parent company; and
>
> (ii) The primary purpose of which is to finance the business operations of its parent company or companies controlled by its parent company.

Although the rule defines "finance subsidiary" as a "corporation" that satisfies the conditions in clauses (i) and (ii), the SEC staff has taken the position that finance subsidiaries organized as partnerships issuing nonvoting preferred partner interests, *Andrews & Kurth* (avail. Apr. 5, 1994), as limited liability companies issuing nonvoting preferred member interests, *Lehman Brothers Inc.* (avail. Mar. 8, 1994); *Merrill Lynch & Co.* (avail. Mar. 2, 1994), or as business trusts issuing preferred securities, *Lehman Brothers Inc.* (avail. May 26, 1995), debt securities or other securities representing nonvoting preferred beneficial interests, *Merrill Lynch & Co.* (avail. May 25, 1995), or nonvoting preferred trust certificates, *Goldman, Sachs & Co.* (avail. Apr. 27, 1995), may rely on the exemption for finance subsidiaries so long as the subsidiaries and the related transactions comply fully with the remaining requirements of the rule.

59 "[P]arent company" is defined in Rule 3a-5(b)(2) under the Investment Company Act as any corporation, partnership or joint venture:

> (i) That is not considered an investment company under section 3(a) or that is excepted or exempted by order from the definition of investment company by section 3(b) or by

> the rules or regulations under section 3(a);
>
> (ii) That is organized or formed under the laws of the United States or of a state or that is a foreign private issuer, or that is a foreign bank or foreign insurance company as those terms are used in [R]ule 3a-6 [under the Investment Company Act]; and
>
> (iii) In the case of a partnership or joint venture, each partner or participant in the joint venture meets the requirements of paragraphs (b)(2)(i) and (ii).

60 "[C]ompany controlled by the parent company" is defined in Rule 3a-5(b)(3) under the Investment Company Act as any corporation, partnership or joint venture:

> (i) That is not considered an investment company under section 3(a) or that is excepted or exempted by order from the definition of investment company by section 3(b) or by the rules or regulations under section 3(a);
>
> (ii) That is either organized or formed under the laws of the United States or of a state or that is a foreign private issuer, or that is a foreign bank or foreign insurance company as those terms are used in [R]ule 3a-6 [under the Investment Company Act]; and
>
> (iii) In the case of a corporation, more than 25 percent of whose outstanding voting securities are beneficially owned directly or indirectly by the parent company; or
>
> (iv) In the case of a partnership or joint venture, each partner or participant in the joint venture meets the requirements of paragraphs (b)(3)(i) and (ii), and the parent company has the power to exercise a controlling influence over the management or policies of the partnership or joint venture.

"[F]oreign private issuer" is in turn defined as "any issuer which is incorporated or organized under the laws of a foreign country, but not a foreign government or political subdivision of a foreign government." Rule 3a-5(b)(4) under the Investment Company Act. The definitions of "foreign bank" and "foreign insurance company" are discussed *infra* at Notes 81–82 and accompanying text.

61 *See Brown & Wood* (avail. Feb. 24, 2000).

62 In no-action correspondence relating to Rule 6c-9 under the Investment Company Act, now rescinded but which provided a similar exemption for foreign banks, the SEC staff concluded that cash-settled stock index warrants constitute debt for purposes of the rule where the warrants in question (warrants on certain broad-based indices, such as the S&P 500 Index and the Nikkei Index) represented direct obligations of the issuer to pay the cash value of warrants on their exercise date and would rank *pari passu* with all present and future unsecured senior debt of the issuer. The staff also noted that the warrants were expected to receive investment grade debt ratings from one or more nationally recognized national statistical rating organizations and that the warrants would not entitle their holders to any of the rights normally incident to equity securities, such as voting rights. *Barclays Bank PLC* (avail. Mar. 16, 1991). In that context, the SEC has also taken the position that preferred stock having limited voting rights in extraordinary circumstances, such as in connection with the liquidation of the issuer or a modification of the terms of the preferred stock, would constitute "nonvoting preferred stock." *Barclays Bank PLC* (avail. June 26, 1989).

63 Rule 3a-5 permits the parent guarantee to be subordinated in right of payment to other debt of the parent (Rules 3a-5(a)(1) and 3a-5(a)(2)), although security holders must have the right, pursuant to the terms of the

guarantee, to institute suit directly against the parent without first proceeding against the subsidiary (Rule 3a-5(a)(3)). Although there is no published no-action letter addressing the point, a parent guarantee that ranks *pari passu* with preferred stock of the parent would apparently also constitute a guarantee in compliance with the rule. A "guarantee" of preferred stock need only cover dividends after they are declared. *Cleary, Gottlieb, Steen & Hamilton* (avail. Dec. 23, 1985); *see also Chieftain International Funding Corporation* (avail. Nov. 3, 1992); *In the Matter of Echo Bay Finance Corp.*, SEC Release Nos. IC-18802 (June 22, 1992) (notice of application) and IC-18848 (July 15, 1992) (Order) (exemption from requirement to guarantee liquidation preference with respect to preferred stock).

64 SEC Release No. IC-16093 (Oct. 29, 1987). Certain precedents suggest, however, that the SEC might grant an exemption under § 6(c) of the Investment Company Act in the case of a finance subsidiary that otherwise meets the requirements of Rule 3a-5 but issues securities publicly with the benefit of a parent keepwell rather than a guarantee. 52 Fed. Reg. 42,280, 42,282 (Nov. 4, 1987). The exclusion of keepwell arrangements from Rule 3a-5 has raised particular difficulties for finance subsidiaries of Japanese companies, which for Japanese regulatory reasons much prefer "strong" keepwell arrangements, providing enforceable undertakings that the parent assure that the subsidiary has sufficient resources to meet its obligations and even that the parent's undertakings are directly enforceable by the holders of the subsidiary's securities benefiting from the keepwell, rather than guarantees. These difficulties have been significantly ameliorated by clarification that the guarantee requirement does not apply to either offerings outside the United States under Regulation S under the Securities Act, or to offerings sold in private placements as discussed below.

65 *See infra* Note 81 and accompanying text.

66 SEC Release No. IC-18381 (Oct. 29, 1991).

67 Rule 3a-5(a)(7) under the Investment Company Act. In so amending Rule 3a-5, the SEC was responding to concerns that many banks may not provide guarantees under applicable law. SEC Release No. IC-18381 (Oct. 29, 1991).

68 Rule 3a-5(a)(4) under the Investment Company Act.

69 Rule 3a-5(a)(5) under the Investment Company Act. The SEC has granted an exemptive order under § 6(c) to the effect that a company eligible to receive loans under Rule 3a-5(a)(5) could include a company otherwise meeting the definition of a "company controlled by a parent company" that engages in certain activities, including: (i) providing financing to the parent's subsidiaries through loans and through the purchase of accounts receivable, (ii) investing in temporary investments, (iii) receiving short-term funds on an ongoing basis from the parent's subsidiaries and others, and (iv) participating in a continuous program of short-term lending so long as the company only holds securities that are either permitted under Rule 3a-5(a)(6), have a remaining maturity of no greater than 12 months or consist of accounts receivable from the parent's subsidiaries. The primary purpose of the finance subsidiary must also continue to be the lending of money to the parent company or a company controlled by the parent company in accordance with their business needs. Rule 3a-5(b)(1)(ii) under the Investment Company Act; *In the Matter of IBM International Finance, N.V.*, SEC Release Nos. IC-19548 (June 29, 1993) (notice of application) and IC-19602 (July 28, 1993) (Order). In the exemptive order, the SEC took the position that a back-to-back loan from a finance subsidiary to a parent company or a company controlled by a parent company, where the subsidiary deposits funds with a bank that are in turn loaned to a specified subsidiary of the parent company, although appearing as a bank deposit on the books of the subsidiary, may be included within the 85% minimum investment required by Rule 3a-5(a)(5) and within the investments permitted by Rule 3a-5(a)(6) under the Investment Company Act. *In the Matter of IBM International Finance*, SEC Release No. IC-19602 (July 28, 1993) (Order).

70 The SEC staff has taken the position that an investment in money market mutual fund shares, repurchase agreements with respect to U.S. government securities and demand and time deposits of foreign banks, even if such deposits may not satisfy § 3(a)(3) of the Securities Act, are permitted investments under Rule 3a-5(a)(6) under the Investment Company Act. No percentage limitations apply to such an investment.

Hewlett-Packard Finance Company (avail. July 17, 1996); *see also Hewlett-Packard Finance Company* (avail. Oct. 7, 1992); *In the Matter of IBM International Finance, N.V.*, SEC Release Nos. IC-19548 (June 29, 1993) (notice of application) and IC-19602 (July 28, 1993) (Order).

71 Rule 3a-5(a)(6) under the Investment Company Act.

72 Rules 3a-5(b)(2) and 3a-5(b)(3) under the Investment Company Act.

73 Section 3(c)(3) of the Investment Company Act exempts from the definition of "investment company" U.S. banks, insurance companies and related entities. Rule 3a-6(a), in turn exempts foreign banks and insurance companies. *See* text accompanying *infra* Notes 81–85.

74 In granting an exemptive order under § 6(c), the SEC took the position that the parent company or the controlled company to which the proceeds are loaned may also be a company that qualifies for an exemption from the Investment Company Act pursuant to § 3(c)(5)(A) or § 3(c)(5)(B) solely by reason of its holding accounts receivable of its customers or of other subsidiaries of the parent company or the controlled company, or by reason of loans made by it to those customers or subsidiaries. *In the Matter of IBM International Finance, N.V.*, SEC Release Nos. IC-19548 (June 29, 1993) (notice of application) and IC-19602 (July 28, 1993) (Order).

75 Section 3(c)(6) of the Investment Company Act exempts from the definition of "investment company" companies predominantly engaged in banking activities described in § 3(c)(3), lending activities described in § 3(c)(4) or receivables financing activities described in § 3(c)(5).

76 *In the Matter of MetLife, Inc.*, SEC Release Nos. IC-29101 (Dec. 30, 2009) (notice of application) and IC-29124 (Jan. 26, 2010) (Order).

77 *See* text accompanying *infra* Notes 81–88.

78 *Sony Capital Corp.* (avail. Apr. 27, 1992) (private placement permitting resales under Rule 144A); *PSEG Capital Corp.* (avail. July 13, 1988); *see also General Electric Overseas Capital Corp.* (avail. July 7, 1983). The private placements involved in these letters provided for resales to be conducted solely under Rule 144A or otherwise to certain sophisticated investors—apparently for the life of the securities—leaving open the question whether Rule 3a-5 would continue to be available if the securities were "held by" the U.S. public as a result of resales in accordance with Rule 144 under the Securities Act. The better view, based on the staff's positions in the case of securities offered under Regulation S under the Securities Act (which may trade freely into the U.S. public market after expiration of any applicable distribution compliance period), would seem to be that the exemption would continue to be available. *See also KDSM, Inc., Sinclair Capital* (avail. Mar. 17, 1997).

79 *See* § 7.02[3].

80 *Société Générale* (avail. Feb. 14, 1992); *MEC Finance USA, Inc.* (avail. Oct. 25, 1991).

81 Being "[e]ngaged substantially in commercial banking activity" continues to be defined, as previously provided in Rule 6c-9 under the Investment Company Act, as being

> engaged regularly in, and deriving a substantial portion of its business from, extending commercial and other types of credit, and accepting demand and other types of deposits, that are customary for commercial banks in the country in which the head office of the banking institution is located.

Rule 3a-6(b)(2) under the Investment Company Act. The SEC staff has taken the position that time deposits and interbank deposits can qualify as "deposits and extensions of credit" within the meaning of Rule 3a-6, where U.S. local banking regulations would treat them as such and as customary banking activities. *Safra Republic Holdings, S.A.* (avail. Apr. 21, 1998).

What constitutes a "substantial portion of its business" is open to interpretation, although it clearly means something less than "principal" or "primary." *See Safra Republic Holdings, S.A.* (avail. Apr. 21, 1998). The SEC staff has rejected a proposed "ten percent test" based on a foreign bank's revenues and assets (with respect to credit extensions) and liabilities (with respect to deposits), but has indicated that, to constitute a "substantial portion," the banking activities of a foreign bank must be more than nominal, and that the bank should generally: (i) be authorized to accept demand and other types of deposits and extend commercial and other types of credit, (ii) hold itself out as engaging in, and engage in, each of those activities on a continuous basis, including actively soliciting depositors and borrowers, (iii) engage in both deposit taking and credit extension at a level sufficient to require separate identification of each in publicly disseminated reports and regulatory filings describing the bank's activities, and (iv) engage in either deposit taking or credit extension as one of the bank's principal activities. *See Seward & Kissel* (avail. Oct. 12, 2005).

82 As defined in § 3(a)(8) of the Securities Act, except for the substitution of supervision by foreign government insurance regulators for the regulators referred to in that section.

83 Entities operated for the purpose of avoiding the Investment Company Act cannot rely on Rule 3a-6.

84 SEC Release No. IC-18381 (Oct. 29, 1991).

85 The treatment of banks under the Investment Company Act amply illustrates the Investment Company Act's breadth. Absent the express exemption contained in § 3(c)(3) of the Investment Company Act, banks and insurance companies would be covered by the Act. That exemption is, however, limited by its terms to U.S. banks and insurance companies, with the result that exemption of foreign banks and insurance companies, other than their U.S. branches and agencies subject to U.S. federal or state supervision, *see* SEC Release No. IC-17681 (Aug. 17, 1990), required special SEC action.

86 Rule 489 under the Securities Act. Rule 489 excepts from this requirement Canadian issuers that are filing Form F-X in connection with an offering made under the U.S./Canadian multijurisdictional disclosure system (*see* Chapter 13) and issuers filing a registration statement with respect to debt securities or nonvoting preferred stock and that have a currently accurate Form N-6C9 (the predecessor to Form F-N) on file with the SEC. Rule 489 under the Securities Act. Filings are not required in connection with offerings not required to be registered under the Securities Act (*e.g.*, private placements).

87 *See* § 15.05[1] and [4].

88 *See* § 15.09[1].

89 Rules 3a-6(b)(1)(iii) and 3a-6(b)(3)(iii) under the Investment Company Act. Rule 3a-6 also expressly includes Canadian trust and loan companies and U.K. building societies as foreign banks. Rule 3a-6(b)(1)(ii) under the Investment Company Act. Although other similar institutions would not be covered by Rule 3a-6, they may seek individual exemptive relief under § 6(c) of the Investment Company Act. *See* SEC Release No. IC-18381 (Oct. 29, 1991); § 15.05[7].

90 Many of these offerings have been made under Schedule B under the Securities Act, which applies to obligations of foreign governments. *See* § 3.05[1].

91 *Compagnie de Financement Foncier*, SEC Release Nos. IC-28835 (July 22, 2009) (notice of application) and IC-28848 (Aug. 13, 2009) (Order). *See also Erste Abwicklungsanstalt* (avail. Oct. 10, 2012) (granting no-action relief to a German government backed winding-up agency established for the purpose of taking over and disposing of the assets, liabilities and exposures of a distressed state-owned bank); *Dexia Municipal Agency* (avail. Dec. 26, 2007) (granting no-action relief to a similar nongovernmental credit institution based on an analysis under § 3(c)(5) of the Investment Company Act, discussed at *infra* Note 102 and the accompanying text).

92 *See, e.g.*, *Banque Francaise du Commerce Extérieur* (avail. June 26, 1975).

93 *See, e.g.*, *Korea Finance Corp.*, SEC Release Nos. IC-29332 (June 25, 2010) (notice of application) and IC-29343 (July 20, 2010) (Order); *Banco de Comercio Exterior de Colombia S.A.*, SEC Release Nos. IC-20992 (Apr. 11, 1995) (notice of application) and IC-21044 (May 5, 1995) (Order); *Western Australian Treasury Corp.*, SEC Release Nos. IC-17617 (July 26, 1990) (notice of application) and IC-17673 (Aug. 14, 1990)

(Order); *Nacional Financiera S.A.*, SEC Release Nos. IC-11584 (Jan. 26, 1981) (notice of application) and IC-11642 (Feb. 23, 1981) (Order). The SEC has given some indication that it may be applying a more flexible policy of granting no-action letters to foreign financial institutions carrying out government development and similar policies. *See Municipality Finance Ltd.* (avail. Apr. 28, 1994) (granting no-action relief for a Finnish credit institution that was essentially a government instrumentality making loans to municipalities for the purchase of merchandise and services). The SEC earlier had appeared to be moving towards favoring more cumbersome exemptive relief under § 6(c) of the Investment Company Act. *Compare Development Finance Corporation of New Zealand* (avail. Jan. 27, 1979) *with Australian Industry Development Corp.* (avail. Aug. 11, 1980). The staff in any event will grant no-action relief where it considers it can rely on a specific exemption under the Act or rules. *See* § 15.05[3]; *see also* the discussion of § 3(c)(5) of the Investment Company Act below in § 15.05[3][a].

94 § 3(c)(5) of the Investment Company Act excludes from the definition of "investment company":

> Any person who is not engaged in the business of issuing redeemable securities, face-amount certificates of the installment type or periodic payment plan certificates, and who is primarily engaged in one or more of the following businesses: (A) purchasing or otherwise acquiring notes, drafts, acceptances, open accounts receivable, and other obligations representing part or all of the sales price of merchandise, insurance, and services; (B) making loans to manufacturers, wholesalers, and retailers of, and to prospective purchasers of, specified merchandise, insurance, and services; and (C) purchasing or otherwise acquiring mortgages and other liens on and interests in real estate.

95 *See* § 15.05[3][b] for a discussion of Rule 3a-7 under the Investment Company Act.

96 *See, e.g.*, *Hellenic Republic* (avail. Jan. 10, 1991); *Islamic Republic of Pakistan* (avail. Jan. 18, 1989); *Hashemite Kingdom of Jordan* (avail. Nov. 21, 1988); *Republic of Turkey* (avail. Nov. 3, 1988); *State of Israel* (avail. Aug. 17, 1988); *see also supra* Notes 90–93 and accompanying text for a discussion of exemptions for other foreign government financing vehicles, such as export-import banks and development banks.

97 The SEC has granted no-action relief where the assets purchased under a mortgage-backed ABA consisted of subordinated interests in whole loans, basing its relief in part on the holder's ability to control the process of foreclosing on the underlying loan, which the SEC viewed as making the investment one in the nature of mortgage interests rather than an interest in a person that invests in mortgage interests (*i.e.*, the participation seller). *Capital Trust, Inc*. (avail. Feb. 3, 2009).

98 *E.g., Bear Stearns & Co.* (avail. Oct. 3, 1986); *Salomon Brothers Inc.* (avail. June 17, 1985); *Shearson Lehman American Express Inc.* (avail. Mar. 20, 1985). Other mortgage-backed ABAs organized in the United States have received § 6(c) exemptions when it was not certain that they would be able to meet the 55% whole loan test. In addition to imposing a 55% requirement, the staff has in other no-action letters placed restrictions on the assets comprising the remaining 45% of the relevant asset pool. *See, e.g.*, *Citytrust* (avail. Dec. 19, 1990); SEC Release No. IC-29779 (Aug. 31, 2011).

99 SEC Release No. IC-29779 (Aug. 31, 2011).

100 *See Econo Lodges of America* (avail. Dec. 22, 1989); *Ambassador Capital Corp.* (avail. Oct. 6, 1986).

101 *Royalty Pharma* (avail. Aug. 13, 2010).

102 *Dexia Municipal Agency* (avail. Dec. 26, 2007) (citing *Municipality Finance Ltd.* (avail. Apr. 28, 1994), discussed in *supra* Note 91, and relying in part on the private nature of the U.S. offering and the special nature of covered bonds).

103 With the adoption of Rule 3a-7 under the Investment Company Act, discussed in § 15.05[3][b], the SEC stated that it had determined not to pursue any amendments to § 3(c)(5) of the Investment Company Act. SEC Release No. IC-19105 (Nov. 19, 1992).

104 *See* text at *supra* Note 2.

105 The SEC staff has taken the position that an ABA involving two or more securities that alone are not redeemable, but when combined give holders direct withdrawal rights, may involve the issuance of redeemable securities, depending upon the restrictions on the investor's ability to withdraw portfolio assets. Facts that the SEC staff has indicated are relevant include: (i) whether a holder's withdrawal right is conditional or absolute, (ii) whether the ABA offers the component securities for sale to holders at the same time or at different times, (iii) whether and how often the ABA sponsors activities (such as auctions and mandatory tender offers) designed to facilitate a holder's ability to acquire the component security or securities and present them for withdrawal, (iv) whether the amount of portfolio securities that a holder may withdraw from the ABA at any time is limited or unlimited, (v) how often a holder may withdraw portfolio securities from the program, (vi) whether or not there is a required "holding period" prior to withdrawal, (vii) the denomination of the securities and the minimum amount needed to withdraw portfolio securities, and (viii) how the withdrawal right is presented to investors. *Brown & Wood* (avail. Feb. 24, 1994).

106 SEC Release No. IC-19105 (Nov. 19, 1992) (the "*Adopting Release*"). Rule 3a-7(a) also allows an issuer to engage in "activities related or incidental" to the pooling of receivables. The SEC has stated that holding assets (which are not "eligible assets," see text accompanying *infra* Note 107), such as money market shares, in a pre-funded account could be viewed as a related activity or incidental activity if this activity supports and is secondary to the issuer's business of pooling receivables. The relevant factors to be considered in reaching a determination on this point include the length of the pre-funding period, the maturity date of the asset-backed securities issued by the issuer and the cash amount deposited in the pre-funded account compared with the total offering proceeds. *See Federated Investors, Inc.* (avail. July 8, 1997).

107 Rule 3a-7(b)(1) under the Investment Company Act. Presumably, assets in default at the time of pledge would also qualify since their probable cash flows can be statistically analyzed, fixed-income securities can be rated based on those cash flows and, by their terms, the assets would convert into cash as required by the rule. The SEC staff has, however, taken the position that cumulative preferred stock that has no predetermined liquidation date is not an eligible asset within the meaning of the rule; the characteristics of a security, and not its label, will be determinative. *Brown & Wood* (avail. Feb. 24, 1994). Unsecuritized commitment fees would also not constitute "eligible assets." *Citicorp Securities, Inc.* (avail. Aug. 4, 1995).

108 *Brown & Wood* (avail. Feb. 24, 1994).

109 "Fixed income securities" are defined in Rule 3a-7(b)(2) under the Investment Company Act as any securities that entitle the holder to receive:

> (i) A stated principal amount; or
>
> (ii) Interest on a principal amount (which may be a notional principal amount) calculated by reference to a fixed rate or to a standard or formula which does not reference any change in the market value or fair value of eligible assets; or
>
> (iii) Interest on a principal amount (which may be a notional principal amount) calculated by reference to auctions among holders and prospective holders, or through remarketing of the security; or
>
> (iv) An amount equal to specified fixed or variable portions of the interest received on the assets held by the issuer; or
>
> (v) Any combination of amounts described [above];

provided, that substantially all of the payments to which the holders of such securities are entitled consist of the foregoing amounts.

110 Rule 3a-7(a)(1) under the Investment Company Act.

111 Allotment securities, when first sold by the underwriter to the public, would also have to meet the rating condition. Issuers that are concerned about the availability of the exemption upon a downgrade in these circumstances could require the underwriters to sell any securities that do not meet the rating condition only in private placements to sophisticated investors. Adopting Release, 57 Fed. Reg. 56,248, 56,252 n.48 (Nov. 27, 1992).

112 SEC Release No. IC-29592 (Mar. 3, 2011), 76 Fed. Reg. 12,896, 12,897 n.11 (Mar. 9, 2011).

113 SEC Release No. IC-29779 (Aug. 31, 2011). The release notes that the purpose of these requirements was not principally to assess creditworthiness but rather the issuer's investor protection measures under the assumption that rating agencies, when providing a rating assessing the credit risk of an asset-backed issuer, evaluated whether the issuer was structured in a manner that also addressed investor protection under the Investment Company Act.

114 *See* § 7.02[3][a]. Rule 3a-7 permits an issuer to issue only noninvestment grade securities, provided that the securities are issued solely to institutional accredited investors and to qualified institutional buyers. *See Citicorp Securities, Inc.* (avail. Aug. 4, 1995).

115 In late 2006, a registration statement was filed for a public offering of securities by an issuer a significant portion of the assets of which consisted (directly or through a subsidiary holding company) of equity interests in so-called "CDOs" that were themselves relying on Rule 3a-7. *See* Highland Financial Trust, Registration Statement No. 333-138334 (Oct. 31, 2006). The question was raised in the course of the SEC staff review of this registration statement whether the sale of the issuer's equity interests to persons who are not "qualified institutional buyers" would violate § 48(a) of the Investment Company Act, which provides that it is unlawful for any person, directly or indirectly, to cause anything to be done through another person that would be unlawful for the first person to do under the Investment Company Act or any rules thereunder, such as Rule 3a-7. The registration statement was subsequently withdrawn by the issuer, which indicated in the withdrawal letter that it might undertake a subsequent private offering in reliance on Rule 155(c) under the Securities Act.

116 Adopting Release, 57 Fed. Reg. 56,248, 56,253 n.54 (Nov. 27, 1992).

117 Rule 3a-7(a)(2) under the Investment Company Act.

118 *Compare* the position under § 3(c)(1) of the Investment Company Act as set forth in *Investment Funds Institute of Canada* (avail. Mar. 4, 1996) *with* the position under § 3(c)(7) under the Investment Company Act as set forth in *Goodwin, Proctor & Hoar* (avail. Feb. 28, 1997), as discussed in § 15.06.

119 Rule 3a-7(a)(3) under the Investment Company Act.

120 Rule 3a-7(a)(4) under the Investment Company Act. The SEC staff has taken the position that the term "trustee" does not include a custodian bank. *Brown & Wood* (avail. Feb. 24, 1994). *But see Global Exempt Certificates of Ownership in NHA MBS Securities Inc.* (avail. Dec. 30, 1994) (confirming that a trustee whose responsibilities are limited to holding legal title to the securities, receiving payments thereon and protecting and enforcing its legal title and the rights of certificate holders against adverse claims or actions meets the requirements of Rule 3a-7).

121 *In the Matter of Citibank N.A.*, SEC Release Nos. IC-28717 (Apr. 29, 2009) (notice of application) and IC-28746 (May 26, 2009) (Order) (granting relief under § 6(c) of the Investment Company Act where, among other things, the underwriter affiliate will not be involved in the operation of the issuer (though it may participate in the selection of assets to be pooled) or provide credit support).

122 Adopting Release, 57 Fed. Reg. 56,248, 56,254 (Nov. 27, 1992).

123 Rule 3a-7(a)(4) under the Investment Company Act.

124 Adopting Release, 57 Fed. Reg. 56,248, 56,255 (Nov. 27, 1992).

125 Adopting Release, 57 Fed. Reg. 56,248, 56,255 (Nov. 27, 1992).

126 In adopting new and amended rules to address the registration, disclosure and reporting requirements for asset-backed securities under the Securities Act and the Exchange Act, the SEC has requested further comment on the treatment of synthetic securitizations under Rule 3a-7. SEC Release No. 33-8518 (Dec. 22, 2004). Synthetic securitizations are designed to create exposure to an asset that is not transferred to or otherwise part of the asset pool from which payments on the asset-backed securities are meant to be made. This exposure is often created through the use of derivatives such as credit default or total return swaps. One question that can arise under these securitizations is whether the right to receive payments on the securities depends "primarily" on the cash flow from eligible assets included in the pool. *See* text accompanying *supra* Note 109.

127 The term "cash items," which are excluded from the valuation of an issuer's total assets under subsection (a) of the rule, is not defined by the Investment Company Act but is generally narrowly construed. However, the SEC has stated that shares of registered money market funds subject to Rule 2a-7 are the equivalent of cash items for purposes of Rule 3a-1. *Willkie Farr & Gallagher* (avail. Oct. 23, 2000).

128 "Control" as defined in § 2(a)(9) of the Investment Company Act means "the power to exercise a controlling influence over the management or policies of a company, unless such power is solely the result of an official position with such company." Section 2(a)(9) further states that "[a]ny person who owns beneficially, either directly or through one or more controlled companies, more than 25 per centum of the voting securities of a company shall be presumed to control such company." Although this presumption may be rebutted, it remains effective "until a determination to the contrary [is] made by the [SEC]."

129 *See* SEC Release No. IC-10937 (Nov. 13, 1979).

130 Where, for example, management of the company must be jointly exercised by both owners of control blocks, the company would not be "controlled primarily" by either such owner. *See* SEC Release No. IC-10937 (Nov. 13, 1979).

131 Rule 3a-1(a)(4)(ii) under the Investment Company Act.

132 *See* SEC Release No. IC-10937 (Nov. 13, 1979).

133 Rule 3a-1(b) under the Investment Company Act.

134 SEC Release No. IC-10937 (Nov. 13, 1979).

135 *See* § 15.02.

136 *See* § 15.05[1].

137 Rule 3a-2 under the Investment Company Act.

138 Rule 3a-2 under the Investment Company Act. Note, however, that the SEC has granted an exemptive order under § 6(c) to a company that was unable to reduce its holdings of investment securities within a year of becoming a "transient investment company" to effectively extend the one-year period for two additional years. *In the Matter of Cohesion Technologies, Inc.*, SEC Release Nos. IC-24425 (Apr. 27, 2000) (notice of application) and IC-24462 (May 23, 2000) (Order); *see also Price Communications Corp.*, SEC Release Nos. IC-25533 (Apr. 23, 2002) (note of application) and IC-25579 (May 22, 2002) (Order under § 6(c) exempting a cellular telephone company that, as part of the contemplated liquidation of its business, had contributed its business to a limited partnership in return for a 45% interest in the partnership along with certain significant management and other rights with respect to the partnership, from all provisions of the Investment Company Act for up to four years).

139 Rules 3a-2(a)(1) and 3a-2(a)(2) under the Investment Company Act.

140 In recent years, there has been a proliferation of securities offerings by "blank check companies" or "SPACs" that have no operations and no specific business plan other than to engage in a merger with or acquisition of a company or companies yet to be identified. Rule 419 under the Securities Act requires that

the proceeds from such offerings, if they involve the issuance of "penny stock" (as defined in Rule 3a51-1 under the Exchange Act), be deposited in an escrow account, invested in bank deposits, money market funds or U.S. government securities, and returned to the investors if they have not been released from escrow and used for an acquisition within 18 months after the offering. The adopting release noted that, although the escrow account established pursuant to Rule 419 may be an investment company under the Investment Company Act, in light of the purposes served by the regulatory requirement to establish such an account, the limited duration of the account and the limited nature of the investments, such an account will neither be required to register as an investment company nor regulated as an investment company as long as it meets the requirements of Rule 419. SEC Release No. IC-18651 (Apr. 13, 1992), 57 Fed. Reg. 18,037, 18,040 (Apr. 28, 1992).

Rule 419 does not apply to many of the so-called "SPAC" offerings that have been done because they do not involve the issuance of penny stock. The trust account arrangements that are customarily employed in these SPAC offerings, however, have a similarly limited purpose and duration (though they frequently last up to 30, rather than 18, months) and provide for the similarly limited investments permitted by Rule 419, and are therefore not considered to create investment companies.

141 SEC Release No. IC-10943 (Nov. 16, 1979). In a subsequent release, the SEC clarified that an issuer's intent to satisfy the requirements of Rule 3a-1(a) would not necessarily satisfy Rule 3a-2's required intent to be involved primarily in a business other than being an investment company. SEC Release No. IC-11552 (Jan. 14, 1981).

142 Rule 3a-2(c) under the Investment Company Act.

143 Rule 3a-8 under the Investment Company Act.

144 *See* SEC Release No. IC-26077 (June 16, 2003) (adopting Rule 3a-8 under the Investment Company Act).

145 In addition to the four principal criteria, a company may not hold itself out as being engaged, or be primarily engaged, in the business of investing, reinvesting or trading in securities.

146 "Capital preservation investment" is defined by Rule 3a-8 to mean "an investment that is made to conserve capital and liquidity until the funds are used in the issuer's primary business or businesses." Rule 3a-8(b)(4) under the Investment Company Act. The rule requires that a company's board of directors adopt a written investment policy with respect to its capital preservation investments. Rule 3a-8(a)(7) under the Investment Company Act. In a recent no-action letter, the SEC staff clarified that what constitutes a capital preservation investment, including the appropriate tenor of the investment, will depend on the particular facts and circumstances of the relevant research and development company's business and the terms of the investment. *Ark Therapeutics Group plc* (avail. Apr. 15, 2005). In appropriate circumstances, capital preservation investments can include securities that are not denominated in U.S. dollars or that are non-U.S. securities. *Ark Therapeutics Group plc* (avail. Apr. 15, 2005).

Rule 3a-8 permits a company relying on the rule to acquire investments that are not capital preservation investments if (i) no more than ten percent of the company's total assets consists of such investments or (ii) no more than 25% of the company's total assets consists of such investments so long as at least 75% of those investments were made pursuant to collaborative research and development arrangements. *See* Rule 3a-8(a)(4) under the Investment Company Act.

147 *See* §§ 2(a)(9), 3(b)(2), 6(b), 6(d), 8(f), 10(e), 10(f), 16(a), 17(b), 17(f), 18(i), 22(e)(3), 23(b) and 23(c)(3) of the Investment Company Act.

148 Section 6(c) of the Investment Company Act provides that

> [t]he [SEC], by rules and regulations upon its own motion, or by order upon application, may conditionally or unconditionally exempt any person, security, or transaction, or any class or classes of persons, securities, or transactions, from any provision or provisions of [the Investment Company Act] or of any rule or regulation thereunder, if and to the extent that

> such exemption is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of [the Investment Company Act].

149 Some variation exists among the statutory standards for granting exemptive relief under the many provisions of the Investment Company Act that authorize such relief. Exemptive relief under § 6(b) of the Investment Company Act is, for example, conditioned solely on a finding by the SEC that relief is consistent with the protection of investors.

Exemptive orders under § 6(c) suggest some degree of uniformity in the SEC's treatment of asserted bases for satisfying the statutory standard. For example, the SEC has considered the sophistication of investors in a proposed fund, the existence and adequacy of alternative regulation and the terms of the securities themselves (*e.g.*, whether the securities provide for restrictions on transfer) to be relevant to a determination as to whether the exemption is appropriate in light of the § 6(c) standard. *See, e.g.*, *Condren Housing Partners*, SEC Release Nos. IC-6807 (Nov. 3, 1971) (notice of application) and IC-6851 (Nov. 29, 1971) (Order); *National Corp. for Housing Partnership*, SEC Release Nos. IC-5945 (Dec. 29, 1969) (notice of application) and IC-5955 (Jan. 13, 1970) (Order); *BP No. Am. Fin. Corp.*, SEC Release Nos. IC-4332 (Aug. 20, 1965) (notice of application) and IC-4350 (Sept. 9, 1965) (Order). To demonstrate consistency with the policies "fairly intended" by the Investment Company Act, an applicant must show that the abuses addressed by the Act would not arise if the exemption were granted and that the purposes of the provision from which relief is sought will be preserved. That a particular scheme existed at the time of the adoption of the Investment Company Act will often be fatal to an application under § 6(c), although the proposed creation of a novel pooled investment vehicle or unforeseen circumstances is generally in and of itself not a sufficient basis on which to grant relief. *See* Tamar Frankel, Arthur B. Laby & Ann T. Schwing, THE REGULATION OF MONEY MANAGERS MUTUAL FUNDS AND ADVISERS (3d ed. 2015).

150 There was some concern expressed at the time of the Concept Release that the SEC may have concluded, contrary to both the language of the statute and its legislative history, that there may be limits on its exemptive authority under § 6(c) of the Investment Company Act. In particular, there was concern that the SEC had reached this conclusion with respect to provisions of the Investment Company Act that contain specific numerical or other limitations or that are introduced by a clear prohibition, such as "it shall be unlawful…." *See* Letter from Merrill Lynch & Co., Inc. to Jonathan G. Katz, Secretary, SEC (Oct. 18, 1990).

151 In hearings before the U.S. House of Representatives, the then-Chief Counsel for the Commission Trust Study stated that § 6(c) was included to alleviate "the difficulty of making provision for regulating any industry which has so many variants and so many different types of activities." Hearings on S. 3580 Before a Subcommittee of the Committee on Banking and Currency, 76th Cong., 3d Sess. 197 (1940).

152 *See, e.g., Worldwide Fund Ltd.*, SEC Release Nos. IC-3318 (Aug. 25, 1961) (notice of application) and IC-3327 (Sept. 18, 1961) (Order).

153 These companies are often in danger of qualifying as investment companies under § 3(a)(1)(C) of the Investment Company Act because 40% or more of their total assets might be deemed to be "investment securities" due to the minority interests that they hold in foreign operating companies, either because of local laws that restrict foreign ownership in the local enterprises or because of stakes held by other strategic partners in the operating companies. *See* text accompanying *supra* Notes 33–37. Legislative history related to the passage of the NSMIA indicates that Congress intended the SEC to exempt U.S. companies from regulation as investment companies where those companies engaged in foreign infrastructure projects in jurisdictions that limited their ability to acquire a majority interest in the projects. *See* H.R. Rep. No. 104-622, at 19 (1996) (stating expectation that the SEC would "take administrative action expeditiously … to exempt from regulations as investment companies U.S. companies that own substantial interests in foreign infrastructure companies and that are … actively involved in foreign infrastructure projects").

154 Many of these orders have been requested by companies seeking to make investments in foreign telecommunications ventures. *See, e.g.*, *Propel, Inc.*, SEC Release Nos. IC-24633 (Sept. 6, 2000) (notice of application) and IC-24673 (Oct. 3, 2000) (Order). In the *Propel* order, for example, the company sought, and obtained, an exemption under § 6(c) that permitted it, among other things, to make investments in foreign telecommunications companies, provided that the company (directly or indirectly) acquired at least a 10% economic or voting interest in each foreign telecommunications company and provided active developmental assistance to each such company. *Propel, Inc.*, SEC Release No. IC-24633 (Sept. 6, 2000) (notice of application); *see also Telesystem International Wireless Inc.*, SEC Release Nos. IC-23618 (Dec. 22, 1998) (notice of application) and IC-23658 (Jan. 20, 1999) (Order); *Formus Communications, Inc.*, SEC Release Nos. IC-23486 (Oct. 14, 1998) (notice of application) and IC-23530 (Nov. 10, 1998) (Order); *Tele-Communications International*, SEC Release Nos. IC-22797 (Aug. 22, 1997) (notice of application) and IC-22825 (Sept. 17, 1997) (Order); *Enron Corp.*, SEC Release Nos. IC-22515 (Feb. 14, 1997) (notice of application) and IC-22560 (Mar. 13, 1997) (Order).

155 SEC Release No. IC-14492 (Apr. 30, 1985).

156 Since 2008, the SEC has required that applications for orders under the Investment Company Act, including exemptive orders, be submitted *via* EDGAR. *See* SEC Release No. 33-8981 (Oct. 29, 2008).

157 1992 Report at 509 n.28.

158 *See, e.g.*, Letter from Davis, Polk & Wardwell (Oct. 10, 1990).

159 SEC Release No. IC-19362 (Mar. 26, 1993).

160 SEC Release No. 34-35483 (Mar. 14, 1995); *see also* SEC Release No. 34-35483A (Mar. 21, 1995) (correcting final rule).

161 The SEC removed consideration of the reforms to Rule 0-5 from its regulatory agenda in 1996, but stated that it may consider the reforms at some future point. SEC Release No. IC-21795 (Mar. 4, 1996).

162 *See, e.g.*, *Yahoo! Inc.*, SEC Release Nos. IC-24459 (May 18, 2000) (notice of application) and IC-24494 (June 13, 2000) (Order); *Bill Gross' idealab!*, SEC Release Nos. IC-24642 (Sept. 15, 2000) (notice of application) and IC-24682 (Oct. 10, 2000) (Order).

163 *See* § 2(a)(9) of the Investment Company Act.

164 *Yahoo! Inc.*, SEC Release No. IC-24494 (June 13, 2000); *Bill Gross' idealab!*, SEC Release No. IC-24682 (Oct. 10, 2000). Note, however, that an application by Yahoo! several years earlier had not been successful. In addition, the SEC staff has indicated informally that it would no longer be receptive to applications for exemptions by such companies.

165 *See SeaCo Ltd.*, SEC Release Nos. IC-29176 (Mar. 17, 2010) (notice of application) and IC-29206 (Apr. 9, 2010) (Order).

166 *See Tonopah Mining Company of Nevada*, 256 SEC 426, 427 (1947). In a potentially significant ruling, the court in *SEC v. National Presto Industries*, 486 F.3d 305 (7th Cir. 2007), applied the *Tonopah* facts to conclude that, even though it had not sought an exemptive order under § 3(b)(2) as suggested by the SEC, an issuer that was actively engaged in an operating business could rely on the exemption under § 3(b)(1) of the Investment Company Act for companies that are "primarily engaged, directly or through a wholly-owned subsidiary or subsidiaries, in a business or businesses other than that of investing, reinvesting, owning, holding or trading in securities," notwithstanding the fact that more than 40% of its assets comprised investment securities so that it would otherwise be considered an inadvertent investment company under § 3(a)(1)(C) of the Investment Company Act. *See* § 15.02. Law firms have generally been hesitant about providing opinions relying on § 3(b)(1) because of its heavily factual and arguably subjective nature, and because of the SEC's strong emphasis on the asset test as being essentially dispositive absent another specifically applicable exemption. However, in at least one instance, the SEC was willing, based on an analysis using the *Tonopah* criteria under § 3(b)(1), to grant no-action relief rather than requiring an exemptive order under § 3(b)(2). *See Accor Services* (avail. June 7, 2010). More recently, the SEC applied the *Tonopah* criteria and *National Presto* analysis to find that a public medical device manufacturer that had

failed to commercialize and generate a net operating profit based on its medical device was an investment company because 90% of its assets and 90% of its income were derived from investment securities and, among other things, the company did not seek to protect its financial assets and instead invested in equities and paid dividends to shareholders. *In the Matter of Daxor Corporation*, SEC Admin. Proc. File No. 3-14055 (Aug. 31, 2011). Notably, rather than giving the five *Tonopah* criteria equal weight, the SEC emphasized these quantitative criteria as being of primary importance.

U.S. Regulation of the International Securities and Derivatives Markets, § 15.06, PRIVATE OFFERINGS BY FOREIGN FUNDS: *TOUCHE REMNANT* AND §§ 3(c)(1) AND 3(c)(7)

U.S. Regulation of the International Securities and Derivatives Markets
1 Edward F. Greene, Alan L. Beller, Edward J. Rosen, Leslie N. Silverman, Daniel A. Braverman, Sebastian R. Sperber, Nicolas Grabar & Adam E. Fleisher, U.S. Regulation of the International Securities and Derivatives Markets § 15.06 (11th and 12th Editions 2014-2017)
11th and 12th Editions

[1] Private Offerings to Qualified Purchasers Under § 3(c)(7)

Section 3(c)(7), added to the Investment Company Act in 1996 by the NSMIA, facilitates U.S. private offerings by U.S. and non-U.S. investment companies. Section 3(c)(7) excepts from the definition of "investment company" any issuer (i) whose outstanding securities [167] are, with the exception of securities

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held by "knowledgeable employees" of the issuer, [168] owned only by persons who, at the time of acquisition [169] (whether in a primary offering or in the secondary market), the fund or a person acting on its behalf reasonably believes are "qualified purchasers," [170] and (ii) that is not making and does not at such time propose to make a public offering of its securities in the United States. [171] This exception is intended to provide increased flexibility for funds owned exclusively by highly sophisticated investors— "qualified purchasers"—who are thought to possess sufficient investment acumen so as not to require the substantive protections of the Investment Company Act. [172] Unlike § 3(c)(1) of the Investment Company Act, with its 100-owner limit and resulting issues, as discussed below, there is no limit under § 3(c)(7) to the number of qualified purchasers such an issuer may have as investors.

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Section 2(a)(51) of the Investment Company Act, also added by the NSMIA, defines the term "qualified purchaser" as: (i) any natural person who owns not less than $5 million in qualifying investments (including investments held jointly with such person's spouse), [173] (ii) certain family-owned companies, including trusts, owning not less than $5 million in investments that are "owned directly or indirectly by … direct lineal descendents," [174] (iii) certain other trusts [175] or (iv) any person, acting for its own account or the accounts of other qualified purchasers (*i.e.*, institutional investors), who in the aggregate owns and invests on a discretionary basis not less than $25 million in investments. [176] Rule 2a51-1(g) under the Investment Company Act also provides that, with certain

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very limited exceptions, "qualified institutional buyers" (as defined in Rule 144A under the Securities Act) shall be deemed to be qualified purchasers. [177]

Analogizing to its positions under § 3(c)(1) of the Investment Company Act discussed below, the SEC staff has stated that a foreign issuer would be able to avail itself of the exemption provided by § 3(c)(7) of the Investment Company Act if it engaged in no public offerings in the United States and all U.S. residents (pursuant to the definition of "U.S. person" in Regulation S under the Securities Act) that purchased its securities in a primary offering (or a secondary offering involving the foreign issuer or its agents, affiliates or intermediaries) or as part of an unbroken chain of U.S. persons that began with the primary offering (or such a secondary offering) were qualified purchasers. [178] A foreign issuer may qualify for § 3(c)(7) even if U.S. residents who have purchased in the secondary market securities that were initially placed or subsequently resold outside the United States to non-U.S. persons are not qualified purchasers. [179] A foreign fund making a private offering of its securities in the United States must therefore comply with § 3(c)(7) with respect to its securities sold directly to U.S. residents or subsequently transferred by such U.S. residents to other U.S. residents. Securities that flow into the United States in secondary market trading (including securities that are initially placed with U.S. resident investors but that are subsequently sold to non-U.S. persons and flow back to U.S. resident investors in secondary market transactions) need not be counted. [180]

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Where U.S. secondary market transactions must be monitored to ensure that any U.S. resident purchaser is a qualified purchaser, concerns regarding security, convenience, speed of settlement and liquidity have nevertheless led investors and other market participants to favor issuance of securities in global "book-entry" form rather than in physical, registered form. [181] Issuance in global "book-entry" form, however, raises a number of questions. In the ABA Interpretive Letter, the SEC explicitly rejected the suggestion that the requirement that a § 3(c)(7) fund (or a person acting on its behalf) reasonably believe that a purchaser of its securities is a qualified purchaser may be satisfied if the seller of the securities (rather than the fund) forms the reasonable belief. The fund's belief that such purchasers are both qualified institutional buyers and qualified purchasers may also not be formed exclusively on the basis of so-called "deemed" representations now commonly included in the disclosure for Rule 144A transactions—representations as to a purchaser's status that are deemed to be made by prospective investors that receive the offering document. [182] The SEC left open the possibility that a fund could develop procedures in the Rule 144A market that, if followed, would be sufficient to form the requisite reasonable belief. The SEC stated, however, that it will not respond to requests as to whether any particular set of procedures is adequate for this purpose. [183]

Members of a number of major law firms, including ours, have developed, in consultation with The Depository Trust Company ("DTC"), Euroclear and Clearstream Banking, and published a set of procedures that can be implemented to permit § 3(c)(7) monitoring for book-entry securities issued by certain non-U.S. issuers. [184] The procedures appropriate for any particular transaction are

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dependent upon, among other things, the nature of the issuer, whether the securities being offered are debt or equity and the expected level of U.S. interest and trading in the security. Among the more significant procedures applicable to most offerings relying on the 3(c)(7) procedures are:

- disclosure and "deemed" representations concerning transfer restrictions and the status of the purchaser as a qualified purchaser;
- legends on global securities and minimum denominations or purchase amounts;
- a representation by the issuer, based on factors that the issuer and its counsel consider necessary or appropriate, as to the issuer's reasonable belief about the qualified purchaser status of initial and subsequent purchasers;
- representations and covenants by the distributor of the securities, which must be a sophisticated investment bank with the ability to screen purchasers, concerning its own qualified purchaser status and that of investors to which it may make resales;
- the issuer's right under its charter, by-laws or other document, which must also be disclosed to investors, to force a noncomplying holder to resell its securities to an appropriate holder or to redeem the securities;
- periodic reminders from the issuer to securityholders and DTC (and, in the case of a non-U.S. issuer, Euroclear and Clearstream Banking) participants of the § 3(c)(7) restrictions and the issuer's rights as described above;
- notations on any Bloomberg, Telekurs and/or Reuters screen that includes quotations about the

securities as to their § 3(c)(7) status;

- instruction by the issuer to DTC (and, in the case of a non-U.S. issuer, Euroclear and Clearstream Banking) to take certain pre-determined steps to identify the securities as restricted under § 3(c)(7), including the distribution of notices to DTC (and, in the case of a non-U.S. issuer, Euroclear and Clearstream Banking) participants and the provision of information about DTC

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(and, in the case of a non-U.S. issuer, Euroclear and Clearstream Banking) participants to the issuer; and

- the inclusion on trade confirmations of a CUSIP number bearing a "3c7" indicator.

Additional procedures that are appropriate in some circumstances, including offerings of equity securities, include limits on the amount of the offering sold into and the number of purchasers in the United States, requiring representation letters as to "qualified purchaser" status from U.S. investors and using a "gatekeeper" to monitor compliance with restrictions on resales applicable to securities initially sold to U.S. persons.

U.S. issuers must observe these procedures for all holders, whether U.S. or non-U.S. persons. Non-U.S. issuers need not implement these procedures for their non-U.S. holders, who may trade their securities through Euroclear and Clearstream freely. [185]

[2] Private Offerings Under § 3(c)(1) and *Touche Remnant*

For non-U.S. issuers that are or might be investment companies and that wish to sell their securities in a private offering to U.S. investors that are not all qualified purchasers, the SEC's no-action positions under §§ 3(c)(1) and 7(d) of the Investment Company Act effectively preclude them from selling to more than 100-beneficial owners that are U.S. residents. While, as discussed below, practitioners widely believe that the SEC's position is not supported by the statutory provisions of the Investment Company Act, there is little appetite to design offerings that operate directly in conflict with the SEC's position. In addition, the exemption provided by § 3(c)(7) of the Investment Company Act, discussed above, for offerings to an unlimited number of qualified purchasers, has reduced the practical significance of the limitations mandated by the SEC's position.

The ability of foreign investment companies to access the U.S. market in a public offering is governed by § 7(d) of the Investment Company Act, which prohibits a foreign domiciled investment company from making a public offering of its securities in the United States, [186] unless the SEC, upon application by

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the investment company, permits its registration on the basis that it is both "legally and practically" feasible to enforce the provisions of the Investment Company Act against the applicant and that the granting of relief is consistent with the public interest and the protection of investors. [187] The prohibition of § 7(d) of the Investment Company Act is against the use of U.S. jurisdictional means in connection with a public offering. [188] A "public" offering in this context was historically thought to have the same meaning as it did for purposes of determining the need for registration of an offering under the Securities Act. [189] The prohibition was thus for many years thought not to extend to other activities that might result in U.S. beneficial ownership of a fund, such as U.S. private investment or acquisitions in the secondary market by U.S. investors. Foreign

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funds could thus take advantage of the exemptions from Securities Act registration provided in § 4(a)(2) of the Securities Act and Regulation D thereunder. Under Rule 506 of Regulation D, for example, a foreign private investment company could make an offering to an unlimited number of U.S. "accredited investors" and up to 35 other investors and still qualify for safe harbor treatment under the rule.

The staff rejected this interpretation of § 7(d) of the Investment Company Act in *Touche Remnant & Co.*, where it concluded that, even if a foreign fund complied with the requirements of Rule 506 of Regulation D under the Securities Act, [190] the fund would still be subject to registration under the Investment Company Act if "upon completion of the offering there would be more than 100 persons resident in the United States who were beneficial owners of its securities." [191] The staff was careful to emphasize that its conclusion was not based on the fact that the foreign fund was offering its securities publicly outside the United States, but on the legitimate U.S. interest in activities actually conducted in the United States or the effects of the fund's offshore activities on the United States. In that regard, the staff's analysis was two-pronged. First, the staff found that § 3(c)(1) of the Investment Company Act—the so-called "private" investment company exemption [192] that limits beneficial ownership of funds within its purview to 100 persons—evidenced a U.S. regulatory interest in funds having more than 100 investors. Second, the staff asserted that § 7(d) "demonstrates Congress' intent to require foreign investment companies whose conduct has a significant effect on U.S. investors to be subject to the same type of regulation that applies to American investment companies." [193] Absent the 100-U.S. resident limitation, foreign and U.S. funds would be treated unequally, a result that would be, in the staff's view, contrary to the policy expressed in § 7(d). The *Touche Remnant* position has been interpreted to apply not only to closed-end, but also to open-end, funds. [194]

Industry groups, as well as the private securities bar, strongly criticized *Touche Remnant* and, in response to the Concept Release, urged the withdrawal of the staff's position as a matter of both law and policy. [195] The first criticism leveled at the staff's position is that it is inconsistent with the language of § 7(d) and the very structure of the Investment Company Act. Section 7(d) regulates foreign investment companies; the baseline inquiry must thus be whether an entity is an "investment company" within the meaning of the Investment Company Act. If not—because it is, for example, an operating company or falls within a statutory exclusion from the definition, such as § 3(c)(1)—there is no further inquiry under the Investment Company Act. On the other hand, if the entity is an investment company, it is subject to the general prohibitions of § 7 of the Investment Company Act. A comparison of the restrictions set forth in subsections (a) and (b) of § 7 with subsection (d) evidences a clear legislative intent to differentiate between the regulation of domestic and foreign investment companies. In the case of U.S.-domiciled investment companies, §§ 7(a) and 7(b) require registration under the Investment Company Act. In the case of foreign-domiciled investment companies, the language of § 7(d) is clear: the use of the jurisdictional means is forbidden only where used in connection with a public offering in the United States of the securities of the foreign fund. Section 3(c)(1) is thus definitional only.

Moreover, there is no other authoritative legal basis for attributing a different meaning to "public offering" for purposes of the Investment Company Act than that which has developed under the Securities Act. [196] Regulation D and Rule 144A under the Securities Act do not restrict the number of large U.S. offerees or purchasers, whether primary or secondary, in order to avoid a public offering subject to registration under the Securities Act. More important, § 3(c)(1) itself provides convincing evidence that the 100-owner standard cannot be read into § 7(d) of the Investment Company Act. Section 3(c)(1) contains a two-pronged standard requiring that there be no public offering and that there be no more than 100-beneficial owners of the issuer's securities (excluding short-term paper). If exceeding the 100-owner standard by itself resulted in a "public offering" within the meaning of the Investment Company Act, the second prong of § 3(c)(1) imposing the 100-owner limit would be superfluous since it would be

subsumed in the concept of a "public offering." Moreover, there is no indication in the legislative history of the Investment Company Act of any intent to read § 3(c)(1) into the regulation of foreign investment companies and require registration when, as a result of or following a U.S. private placement, a foreign investment company has more than 100 U.S. beneficial owners. [197]

Although there was some disagreement among the private bar, the *Touche Remnant* position has been interpreted by many practitioners to require only that there be no more than 100-beneficial owners of a foreign fund's securities who are U.S. residents immediately following the private placement in the United States (relying, for these purposes, on the definition of "U.S. person" provided by Regulation S under the Securities Act in counting U.S. owners). Under this interpretation, *Touche Remnant* is considered not to apply to secondary market trading in securities placed with non-U.S. persons in a primary offering, so long as the issuer, its agents and affiliates are not involved in that trading. This "snapshot" approach still necessitates an inquiry as to the residence of any owners of the investment company's securities at the time of the placement. Although a difficult task in view of the substantial overseas use of bearer securities and the increasingly widespread practice of holding securities in "street name," this approach does not entail any procedures, such as transfer restrictions, to police secondary flowback into the United States of securities placed initially with non-U.S. persons.

This interpretation has been confirmed by the SEC in *Investment Funds Institute of Canada*, in which the staff noted that *Touche Remnant* and § 7(d) do not "as a general matter" require an issuer to monitor resales of its securities independently made by such holders in secondary market transactions. [198] Therefore, securities of a foreign fund that are initially placed outside the United States

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under Regulation S to non-U.S. persons need not be counted toward the 100-beneficial-owner limit even if they are subsequently transferred to U.S. investors in the secondary market, so long as neither the foreign fund nor any of its agents, affiliates or intermediaries is involved in promoting such transfers. For the purposes of applying the 100-owner test to securities initially sold by the issuer to U.S. persons, it is the view of the authors that one should count (i) securities sold in the United States in previous private offerings that remain in the United States and (ii) securities originally sold to U.S. persons that are either held by the original purchaser or have been resold to other U.S. resident investors and remain owned by U.S. resident investors. Securities that flow into the United States in secondary market trading after the placement, however (including securities that are initially privately offered to U.S. resident investors but that subsequently are sold to non-U.S. persons and then flow back again to U.S. resident investors in secondary market transactions), need not be counted. [199]

Prior to the adoption of § 3(c)(7) of the Investment Company Act, the result of *Touche Remnant* was often that foreign funds and inadvertent investment companies had no practical recourse but to forgo U.S. private offerings that they and their underwriters would otherwise consider. This result in turn forced U.S. institutional investors interested in purchasing these securities into foreign markets to do so. The detailed sales restrictions that would have to be adopted in connection with a U.S. private offering, described below, are not attractive, especially for secondary market transactions of companies listed and publicly traded outside the United States. The alternative of a § 6(c) exemption, which is sometimes pursued in the context of a U.S. public offering by such an issuer, is too time-consuming, expensive and uncertain to be considered as a practical alternative in the context of a private offering—the foreign offering to which the U.S. private offering is probably an adjunct will not wait for the exemptive process to be completed, the U.S. private offering is probably not a crucial element of the overall offering for the issuer (although it might be beneficial to U.S. investors and dealers), and in many cases success in pursuing the exemptive process cannot be guaranteed. The absence of applications for § 6(c) exemptive relief in connection with U.S. private offerings by foreign inadvertent investment companies is empirical evidence that it is not a practical solution to the problems caused by *Touche Remnant*. [200]

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Like domestic funds, a foreign fund may not simultaneously rely on both §§ 3(c)(1) and 3(c)(7) of the Investment Company Act by offering securities in a private placement in the United States both to qualified purchasers and to less than 100 U.S. resident nonqualified purchasers. [201] A foreign fund may, however, make an offshore public offering of its securities in accordance with Regulation S under the Securities Act while at the same time making a private placement under § 3(c)(1) or § 3(c)(7) without causing the offerings to be integrated. In this case, any U.S. persons to whom securities were initially sold by the foreign fund in the offshore public offering would be required, for the purposes of the U.S. private placement as discussed above, to count towards the § 3(c)(1) 100-owner limit or to be qualified purchasers under § 3(c)(7), as applicable. [202]

[3] *Touche Remnant* and Beneficial Ownership Issues Under § 3(c)(1)

[a] General

For foreign funds that choose to rely on § 3(c)(1) rather than § 3(c)(7) of the Investment Company Act, the SEC's *Touche Remnant* doctrine not only requires that a foreign "private" investment company have 100 or fewer beneficial owners who are U.S. residents in order to avoid violation of § 7(d) of the Investment Company Act, [203] but also notwithstanding that § 7(d) is silent on the point, requires consideration of the rules regarding ownership and attribution of ownership under § 3(c)(1) of the Investment Company Act. [204] The latter requirement—even though it has no relation to the number of actual offerees—demonstrates how far the SEC's position has strayed from the § 7(d) "public offering" requirement. In general, any person or entity that has any ownership interest in an investment company's securities, whether debt or equity, is an owner for purposes of determining the 100-U.S.-beneficial owner limitation. Subject to the Investment Company Act's attribution rules discussed below, entities such as corporations and partnerships will generally be treated as a single beneficial owner, [205] although where the owners of such an entity may be deemed to be making a separate investment decision to invest in a private investment fund, the SEC may look through the entity and find each of such owners to be a beneficial owner. [206]

Procedures must be adopted in all cases to determine beneficial ownership, although the types of steps taken by issuers have varied. Where the securities are in registered form, determination of beneficial ownership is a relatively easy inquiry, at least insofar as registration places the issuer on notice of facts that may result in attribution of beneficial ownership. Where a question is raised as to the identity of an issuer's beneficial owners, certifications containing appropriate representations and warranties may be obtained from purchasers. In many cases, additional procedures have been implemented that provide ongoing ability to police U.S. beneficial ownership. Some issuers have, for example, imposed payment and transfer restrictions that prohibit the transfer of, or the payment of

any distribution on, their securities in the absence of certification that the securities are not beneficially owned by U.S. persons.

As noted above, investors and other market participants now broadly favor "book-entry" securities. However, even under the principles of the *Investment Funds Institute of Canada* letter, secondary market sales by a U.S. beneficial owner purchasing in the original offering to another investor (and subsequent transfers in this chain of U.S. resident purchasers) must be monitored to ensure compliance with the 100-U.S.-beneficial owner limitation. This requirement has made practitioners reluctant to permit securities of non-U.S. private investment companies offered in the United States under the strictures of § 3(c)(1) of the Investment Company Act and *Touche Remnant* to be held in global form, for example at DTC, where secondary market transactions cannot generally be monitored. [207] Nonetheless, issuance of such securities in global form has been countenanced in particular transactions where the existence of special circumstances, generally confirmed by the sole manager (or lead manager), permits the conclusion that U.S. secondary trading can be effectively monitored.

In the case of bearer securities, on the other hand, even upon original issuance an issuer cannot know with certainty how many U.S. residents are beneficial owners of its securities. Issuers have derived comfort in these circumstances from a variety of factors, including the absence of any offering of the issuer's securities in the United States or of any active trading market in the United States for the issuer's securities—particularly if the issuer is managed and controlled wholly outside the United States. The selling restrictions for certain offerings with a private placement component have also included specific restrictions on the underwriters not to make a sale in the United States if the underwriter would have reason to believe that, immediately following the sale, there would be more than 100 U.S. residents who beneficially own the issuer's securities.

In addition, issuers sometimes reserve the right to deny transfer in any instance in which the issuer believes that the transfer will result in breach of the 100-U.S.-resident limitation. Issuers also typically include other protections in their articles of incorporation or other constituent documents. Those provisions often require an automatic redemption or repurchase of the issuer's securities (or alternatively permit the issuer to cause such a redemption or repurchase) in any case in which the beneficial ownership restrictions of the Investment Company Act or the related terms of the securities may have been violated. It would appear, however, that even the most rigid of restrictions may not pass SEC muster if there is any possibility that the *Touche Remnant* standard could be violated. [208]

[b] Attribution Rules

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Following the adoption of the NSMIA, the attribution rules of the Investment Company Act are only called into play when an investment company (or an entity that would be an investment company but for the exceptions provided by § 3(c)(1) or § 3(c)(7) of the Investment Company Act) owns "10 per centum or more of the outstanding voting securities of the issuer." In that event, § 3(c)(1)(A) of the Investment Company Act provides that beneficial ownership will be "attributed" to the owners of such investment company's outstanding securities (other than short-term paper), all of which will then be counted against the 100-U.S.-beneficial owner limit. Although the Investment Company Act defines "voting security" as any security entitling the holder "to vote for the election of directors of a company," [209] the SEC has found other types of securities to qualify, such as limited partnership interests that entitle their holders to remove or select a general partner in any but the most restricted of circumstances [210] and securities that represent a sufficiently large economic interest in the investment company to permit the holder to exercise power and control over the investment company. [211]

[c] Integration

Even where procedures are adopted to ensure that a foreign investment company has no more than 100 U.S. residents who are beneficial owners of its securities, the *Touche Remnant* limitations on U.S. beneficial ownership may still be breached if the sponsor of the investment company has sponsored one or more other similar investment companies. [212] In certain circumstances, the SEC has taken the position that two or more funds may be "integrated" for purposes of determining compliance with the private investment company exception contained in § 3(c)(1) of the Investment Company Act. The NSMIA added new § 3(c)(7)(E) of the Investment Company Act providing that a § 3(c)(7) fund will generally not be integrated with a § 3(c)(1) fund. However, a single issuer may not rely on both §§ 3(c)(1) and 3(c)(7) of the Investment Company Act. [213]

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The purpose of the integration doctrine is to prevent circumvention of the Investment Company Act's registration and other requirements through the use of artificially distinct investment vehicles. Where the doctrine is applicable, if the aggregate number of beneficial owners of the integrated funds exceeds the 100-U.S.-beneficial owner limitation, none of the funds will be entitled to be exempted from registration under the Investment Company Act.

Although the application of the integration doctrine requires a highly fact-intensive analysis, the SEC has in no-action letters emphasized several factors relevant to determining whether two or more funds ought to be considered together for purposes of § 3(c)(1) of the Investment Company Act. As stated by the staff of the SEC, a key inquiry is whether an interest in one fund, as compared to a second fund, "would be considered materially different by a reasonable investor qualified to purchase both." [214] In *PBT Covered Option Fund*, the staff refused to take a no-action position where two funds had the same investment objectives, the same types of portfolio securities and similar portfolio risk/return characteristics. The staff concluded that it could not determine that a reasonable investor would find one fund to be materially different from the other. [215] Moreover, artificial differences between funds, such as a condition to investment based on residency in one state as opposed to another, do not provide a sufficient basis on which to conclude that two funds should not be integrated. [216]

The SEC staff's concern for these "cookie cutter" funds has resulted in its issuance of letters refusing no-action positions that contain overly broad language that can inhibit development of legitimate institutional products. Consequently, where the characteristics of two or more funds raise the potential for integration such that the funds together may have more than 100 beneficial owners that are U.S. residents, it may be desirable that the documentation for each fund reflect limitations on the ability of U.S. persons to purchase the funds' securities in the aggregate.

Footnotes

167 Unlike § 3(c)(1) of the Investment Company Act, even holders of short-term paper must meet the qualified purchaser standard. *See American Bar Association Section of Business Law* (avail. Apr. 22, 1999) (the "ABA Interpretive Letter").

168 Rule 3c-5 under the Investment Company Act. The rule encompasses only those employees who actively participate in the management of a fund's investments and does not include those persons who merely obtain information regarding the fund's activities. The SEC has indicated that, as a general matter, marketing and investor relations professionals who act for a fund, attorneys who provide advice to a fund, brokers and traders of a broker-dealer related to a fund and financial, compliance, operational and accounting officers of a fund, would *not* qualify. *See* the ABA Interpretive Letter. However, in a recent no-action letter, the SEC staff emphasized that knowledgeable employee status depends on the relevant facts and circumstances of a particular investment manager's business operations, and indicated that, under certain circumstances, the following individuals could qualify as knowledgeable employees: (i) individuals in charge of information technology or investor relations departments; (ii) members of a policy making group or committee of an investment manager; (iii) research analysts; (iv) members of an analytical risk team; (v) traders; (vi) tax professionals; (vii) attorneys; (viii) employees involved in the investment activities of certain separate accounts; and (ix) the employees of related advisers. *See Managed Fund Accounts* (avail. Feb. 6, 2014). Similarly, securities owned by knowledgeable employees are excluded for the purposes of determining, pursuant to Rule 2a51-3(b) under the Investment Company Act, whether each beneficial owner of a company's securities is a qualified purchaser. *Paragon Advisers, Inc.* (avail. Oct. 1, 1998). Securities held by knowledgeable employees are not excluded, however, for purposes of Rule 2a51-3(a), when a company is formed for the purpose of acquiring securities offered by a § 3(c)(7) fund, in order to avoid permitting nonqualified purchasers to do indirectly what they could not do directly. *Paragon Advisers, Inc.* (avail. Oct. 1, 1998). Persons who participate in the investment activities of "foreign or offshore investment companies" are also eligible for knowledgeable employee status. In addition, the spouse (but not a dependent) of a knowledgeable employee who invests jointly with the employee does not have to be a qualified purchaser or a knowledgeable employee, and the spouse is not counted towards the 100-owner limit under § 3(c)(1) of the Investment Company Act (although a dependent is). A family company trust or similar estate planning vehicle for which the knowledgeable employee is both responsible for investment decisions and the source of funds invested is eligible for knowledgeable employee status. *See* the ABA Interpretive Letter.

169 The status of a qualified purchaser need not be reaffirmed in connection with the crediting of a fund's earnings to an investor's account, although a reinvestment of dividends may, in certain circumstances, be considered an offering of securities. *See* the ABA Interpretive Letter.

170 Rule 2a51-1(h) under the Investment Company Act.

171 § 3(c)(7) of the Investment Company Act.

172 *Goodwin, Procter & Hoar* (avail. Feb. 28, 1997).

173 § 2(a)(51)(A)(i) of the Investment Company Act. Rule 2a51-1 under the Investment Company Act clarifies how the amount of investments owned by a prospective qualified purchaser should be determined. Privately offered funds and employees' securities companies may count their unfunded capital

commitments as "investments" for these purposes. *The BSC Employee Fund, L.P.* (avail. Oct. 14, 1997). Equity interests held by individuals in securities-related businesses structured as partnerships or limited liability companies (rather than corporations) are also "investments," even if not technically "securities." *Sullivan & Cromwell* (avail. Dec. 29, 1997).

174 § 2(a)(51)(A)(ii) of the Investment Company Act. A trust is "owned directly or indirectly by … direct lineal descendants" if the beneficiaries of the trust were lineal descendants of a settlor and related as aunts or uncles and nieces and nephews. A trustee is not an owner for purposes of this provision, which is aimed at identifying the holder of the economic interest (whether present or future, vested or contingent) in the trust. *Meadowbrook Real Estate Fund* (avail. Aug. 26, 1998); the ABA Interpretive Letter. *But see Cabot Wellington, LLC* (avail. June 17, 2008) (recommending no enforcement action be taken with respect to the treatment as a "qualified purchaser" of a § 3(c)(1) fund in which the non-familial executive director and principal investment director (a "qualified purchaser" in his own right) also invests).

175 § 2(a)(51)(A)(iii) of the Investment Company Act. The requirement that "each settlor or other person who has contributed assets to the trust" be a qualified purchaser applies even if the settlor has died. The settlor must have been a qualified purchaser at least once when assets were contributed to the trust. The ABA Interpretive Letter; *see also SCP Private Equity Partners II, L.P.* (avail. June 6, 2006).

176 § 2(a)(51)(A)(iv) of the Investment Company Act. The $25 million threshold may be satisfied by aggregating investments that a person owns with investments that the person invests on a discretionary basis. *Service Corporation International* (avail. Oct. 6, 1998). This approach is consistent with the SEC's interpretation of the definition of a "qualified institutional buyer" in Rule 144A(a)(1)(i) under the Securities Act, which permits aggregation of proprietary and managed holdings. In addition, a company may aggregate its investments with investments of its majority-owned subsidiaries, its parent company (so long as it is a majority-owned subsidiary) and any other majority-owned subsidiaries of its parent. *Service Corporation International* (avail. Oct. 6, 1998). A company is not a qualified purchaser if it was formed for the specific purpose of acquiring a § 3(c)(7) fund's securities, unless each beneficial owner of the company's securities is a qualified purchaser. Rule 2a51-3 under the Investment Company Act. Whether or not a company is formed for that purpose depends on an analysis of all of the surrounding facts and circumstances. Although relevant, the percentage of a company's assets invested in the fund is not determinative of this inquiry. The ABA Interpretive Letter.

177 In the context of employee benefit funds, a fund that is a qualified institutional buyer may not qualify as a qualified purchaser in circumstances where individual participants in the fund have the discretion to decide whether and how much to invest in specific investments, including § 3(c)(7) funds. In those situations, a § 3(c)(7) fund must look through the employee benefit fund to determine whether each beneficial owner of the employee benefit fund is a qualified purchaser. The SEC has provided no-action relief with respect to this look-through requirement in certain circumstances. *See, e.g.*, *Invesco Advisers, Inc.* (avail. Apr. 8, 2014).

Similarly, for purposes of calculating the 100-person limitation applicable to investment companies exempt from registration as such under § 3(c)(1) of the Investment Company Act (*see infra* Note 192), a § 3(c)(1) fund must look through such discretionary employee benefit funds and count each beneficial owner as a separate person.

178 *Goodwin, Procter & Hoar* (avail. Feb. 28, 1997). A foreign investor temporarily present (but not resident) in the United States may purchase an interest in a foreign issuer without having to be a qualified purchaser under § 3(c)(7) of the Investment Company Act. *Wilmer, Cutler & Pickering, Davis Polk & Wardwell* (avail. Oct. 5, 1998).

179 *Goodwin, Procter & Hoar* (avail. Feb. 28, 1997); *see also Investment Funds Institute of Canada* (avail. Mar. 4, 1996).

180 Relying on this interpretation, in 2006, a number of private equity firms established permanent capital vehicles that qualified as "foreign private issuers" for purposes of the Securities Act and that invested the proceeds of their offerings in several U.S. private equity funds managed by such firms. Such funds conducted private placements of their shares outside the United States and listed their shares on non-U.S.

exchanges, such as Euronext Amsterdam, while concurrently offering to U.S. qualified purchasers "restricted depositary units" that allowed them to restrict transfer to U.S. qualified purchasers or to secondary trading on the non-U.S. exchanges.

181 The difficulties of monitoring ownership in the case of bearer securities will presumably raise issues and require special circumstances or imposition of special measures if such securities are used. *See* § 15.06[3][a].

182 *See* Chapter 7. Among other issues, not all qualified institutional buyers are qualified purchasers. Rule 2a51-1(g)(1) under the Investment Company Act excludes (i) dealers that own and invest less than $25 million in securities and (ii) participant-directed employee plans. Moreover, while transfer restrictions in most Rule 144A transactions fall away after six months in the case of Exchange Act-reporting issuers (and one year in the case of all other issuers) due to the availability of public resales under Rule 144 under the Securities Act, restrictions under § 3(c)(7) of the Investment Company Act must be monitored for the life of the fund.

183 *See* the ABA Interpretive Letter.

184 *See New Developments in Procedures for Book-Entry Deposit of Rule 144A Securities by Certain Issuers Relying on Section 3(c)(7) of the Investment Company Act*, INVESTMENT LAWYER (Part I, Mar. 2003; Part II., Apr. 2003). *See Book-Entry Deposit Procedures for Certain Offerings by Non-U.S. Issuers under Section 3(c)(7) of the Investment Company Act*, INVESTMENT LAWYER (June 2008); *see also Investment Company Act Status of Non-U.S. Issuers—Updated Commentary on Book-Entry Deposit Procedures under Section 3(c)(7) of the Investment Company Act*, INVESTMENT LAWYER (Mar. 2012).

Neither the original nor the supplemental procedures are appropriate for U.S. fund issuers seeking to issue securities in book-entry form due to the requirement that they confirm qualified purchaser status for all of their investors—both U.S. and non-U.S.—and the resulting greater potential to end up being held by investors that are not qualified purchasers. U.S. fund issuers, however, could satisfy the reasonable belief standard by, for example, using a private book-entry depositary that functions as a closed system and allows only participants that meet the necessary qualifications. In 2007, a number of new transfer systems (including, for example, systems operated by American Stock Transfer & Trust Company and The Bank of New York), which are able to restrict transfers in securities to investors that are both qualified institutional buyers and qualified purchasers, were established in part to facilitate trading by investors in hedge funds, private equity funds and other alternative asset vehicles for which the book-entry procedures described above would not be appropriate.

185 Generally, secondary sales of securities by non-U.S. persons need not be monitored so long as the issuer (and its affiliates and agents) have not participated in any "secondary market trading" within the meaning of the SEC no-action relief granted in *Goodwin, Procter & Hoar* (avail. Feb. 28, 1997) and *Investment Funds Institute of Canada* (avail. Mar. 4, 1996).

186 The prohibition of § 7(d) is not by its terms limited to U.S. public offerings, although the correctness of this conclusion is clearly supported by the legislative history of the Investment Company Act and decades of market practice and SEC acquiescence. *See* S. Rep. No. 1775, 76th Cong., 3d Sess. 13 (1940); H.R. Rep. No. 2639, 76th Cong., 3d Sess. 13 (1940). The conclusion was confirmed by the SEC in adopting Rule 144A under the Securities Act. SEC Release No. 33-6862 (Apr. 23, 1990).

187 Section 7(d) of the Investment Company Act provides:

> No investment company, unless organized or otherwise created under the laws of the United States or of a State, and no depositor or trustee of or underwriter for such a company not so organized or created, shall make use of the mails or any means or instrumentality of interstate commerce, directly or indirectly, to offer for sale, sell, or deliver after sale, in connection with a public offering, any security of which such company is the issuer. Notwithstanding the

> provisions of this subsection and of Section 8(a) [of the Investment Company Act], the [SEC] is authorized, upon application by an investment company organized or otherwise created under the laws of a foreign country, to issue a conditional or unconditional order permitting such company to register under this title and to make a public offering of its securities by use of the mails and means or instrumentalities of interstate commerce, if the [SEC] finds that, by reason of special circumstances or arrangements, it is both legally and practically feasible effectively to enforce the provisions of [the Investment Company Act] against such company and that the issuance of such order is otherwise consistent with the public interest and the protection of investors.

As originally proposed, § 7(d) would not have authorized the SEC to grant relief from the § 7(d) prohibition against U.S. public offerings by foreign investment companies. H.R. Rep. No. 2639, 76th Cong., 3d Sess. 13 (1940). For a discussion of § 7(d), *see* § 15.08.

188 The SEC staff has clarified that § 7(d) prohibits the use of U.S. jurisdictional means by a foreign investment company only in connection with a public offering in the United States or to U.S. persons, rather than the use of U.S. jurisdictional means generally. To the extent that this clarification is inconsistent with the position previously taken by the SEC staff in *KBS International Ltd.* (avail. Mar. 18, 1985), that position has been expressly superseded. *Goodwin, Procter & Hoar* (avail. Oct. 5, 1998).

189 *Stars & Stripes GNMA Funding* (avail. Apr. 17, 1986); *see also* § 6.01. Subsequent to the elimination of the requirement, in connection with the securities trading safe harbor under the Internal Revenue Code (the "IRC"), that a foreign entity's principal office be located outside the United States, the SEC confirmed that the performance in the United States of those specific activities (typically referred to as the "ten commandments") in connection with a private U.S. offering or an offshore public offering would not implicate § 7(d) as long as those activities that amount to an offer or sale of securities are consistent with the regulatory restrictions on nonpublic offerings or offshore offerings to non-U.S. persons. *Wilmer, Cutler & Pickering, Davis Polk & Wardwell* (avail. Oct. 5, 1998); *Goodwin, Procter & Hoar* (avail. Oct. 5, 1998).

190 In this regard, the *Touche Remnant* letter reversed earlier staff advice that offerings made pursuant to Rule 506 (the only Regulation D safe harbor available to investment companies) were nonpublic offerings for purposes of the § 3(c)(1) "private" investment company exemption from registration as an investment company. *See, e.g., San Jose Capital Corporation* (avail. Feb. 14, 1983); *Ideal Mortgage and Realty Service Corp.* (avail. Jan. 4, 1978) (relating to Rule 146, the predecessor of Regulation D). For a description of Rule 506, including recent changes to the general solicitation and "bad actors" restrictions, see § 7.02[2].

191 *Touche Remnant & Co.* (avail. Aug. 27, 1984).

192 Section 3(c)(1) of the Investment Company Act provides an exception from the definition of "investment company," and, therefore, from registration and compliance with most of the requirements of the Investment Company Act, for "[a]ny issuer whose outstanding securities (other than short-term paper) are beneficially owned by not more than one hundred persons and which is not making and does not presently propose to make a public offering of its securities."

193 *Touche Remnant & Co.* (avail. Aug. 27, 1984).

194 *Touche Remnant & Co.* (avail. Aug. 27, 1984).

195 *See, e.g.*, Letter from Cleary, Gottlieb, Steen & Hamilton (Oct. 12, 1990); Letter from Ropes & Gray (Oct. 9, 1990).

196 For many years following the adoption of the Securities Act and in part based upon SEC staff advice, practitioners addressing the presence of a public offering attached significant weight to the number of offerees and purchasers. *See* § 7.02[1].

Nevertheless, the SEC subsequently rejected the importance of that factor in adopting Regulation D, and the SEC division responsible for administering the Investment Company Act has never explicitly distinguished the public offering concept for purposes of that Act from the context in which the concept has evolved under the Securities Act.

197 *See* S. Rep. No. 1775, 76th Cong., 3d Sess. 13 (1940) ("Foreign investment companies may not … *publicly* offer securities of which they are the issuer in the United States unless the [SEC] finds that these foreign investment companies can be effectively subjected to the same type of regulation as domestic investment companies." (emphasis added).

198 *Investment Funds Institute of Canada* (avail. Mar. 4, 1996). The same principle was applied in *Indosuez Asset Management Asia Ltd* (avail. Feb. 14, 1997), where the SEC stated that a fund would not have to aggregate holders of fund shares that were purchased in offshore secondary market transactions not involving the fund or its affiliates that are deposited in a depositary receipt facility with holders of shares or depositary receipts acquired either in a U.S. private placement or from the fund or its affiliates pursuant to Regulation S under the Securities Act, so long as the fund does not promote the public use of the depositary receipts or take any other action that is intended or could be expected to condition the market in the United States for fund shares or facilitate the creation of a public secondary market for fund shares or depositary receipts. *See also Cantor Fitzgerald & Co.* (avail. June 16, 2004); *Merrill Lynch, Pierce, Fenner & Smith Inc.* (avail. Sept. 3, 1999).

The SEC staff has also confirmed that the definition of "U.S. person" under Regulation S should be used to determine whether to count an entity as a U.S. resident owner for purposes of complying with the § 3(c)(1) exemption *. Goodwin, Procter & Hoar* (avail. Oct. 5, 1998).

199 *See Investment Funds Institute of Canada*, at n.13 (avail. Mar. 4, 1996).

200 The SEC staff also proposed in the 1992 Report that § 7(d) of the Investment Company Act be amended to clarify the application of the Act's registration requirement to foreign-domiciled funds that have not made a public offering of their securities in the United States. The staff's recommended amendments would in effect codify its position taken in *Touche Remnant* that the Investment Company Act applies to foreign investment companies that do not make a public offering in the United States. Under the proposal, a foreign fund that is not otherwise excepted from the definition of "investment company" would be prohibited from using U.S. jurisdictional means: (i) to offer, sell or deliver any of its securities or (ii) to facilitate U.S. secondary market trading in its securities, including through listing on an exchange and quotation by a registered "securities information processor," if the fund has, or as a result of either of these activities "can reasonably expect" to have, more than 100 shareholders of record (as opposed to beneficial owners under *Touche Remnant*) that are U.S. residents. 1992 Report at 218–19. Because the staff's recommendation regarding § 7(d) would have effectively legislated compliance with *Touche Remnant*, it was not supported by market participants or the private bar. The staff's recommendation, which was part of a broader proposal to clarify the operation of § 7(d) that raises a number of controversial issues, see § 15.08, has not in fact received significant attention from U.S. legislators, and Congressional initiatives to revise § 7(d) are not expected in the near term.

201 *Goodwin, Procter & Hoar*, at n.10 (avail. Oct. 5, 1998); *see also The Townsend Group*, *Inc.* (avail. July 9, 2008).

202 *Goodwin, Procter & Hoar* (avail. Oct. 5, 1998).

203 Note that an investor who becomes a knowledgeable employee of a fund after purchasing securities of that fund may be treated as having been a knowledgeable employee at the time of the prior purchase and thus cease to be counted for the 100-owner limit test. *See* the ABA Interpretive Letter, *supra* Note 167.

204 *See* SEC Release No. 33-6862 (Apr. 23, 1990).

205 § 3(c)(1)(A) of the Investment Company Act.

206 *See, e.g.*, *Tyler Capital Fund, L.P./South Market Capital* (avail. Sept. 28, 1987). On the other hand, the SEC has taken the position that shares of a § 3(c)(1) fund that are jointly owned by both spouses should be considered to be owned by one beneficial owner, even where each spouse may have discretionary authority over the shares. *See* SEC Release No. IC-22597 (Apr. 3, 1997), 62 Fed. Reg. 17,512, 17,518

n.69 (Apr. 9, 1997); *see also* the ABA Interpretive Letter.

In a 2005 no-action letter, the SEC staff also concluded that the look-through requirement would not apply to a deferred compensation plan in which the amount that plan participants deferred would be paid by the employer to participants at a later time after being adjusted for the performance of a "benchmark" selected by the individual participant from among a group of possible benchmarks designated by the plan's committee. Benchmarks could be based on the performance of individual investment indices, registered investment companies and/or individual § 3(c)(1) or § 3(c)(7) funds. In reaching its conclusion, the SEC staff relied, among other factors, on the employer's representations that (i) the plan was not formed for the purpose of investing in a particular § 3(c)(1) or § 3(c)(7) fund, (ii) the plan committee would act in accordance with the "prudent man" standard set forth in § 404(a)(1)(B) of the Employee Retirement Income Security Act of 1974, as amended ("ERISA") (*see* § 15.07[1][a]) in connection with the selection and retention of any § 3(c)(1) or § 3(c)(7) fund as a performance benchmark under the plan, and (iii) the plan committee would not condition the selection of any § 3(c)(1) or § 3(c)(7) fund on the agreement of such fund to use the employer (The Goldman Sachs Group, Inc.) or any of its affiliates as a prime broker. Also of relevance were the fact that the employer was not obligated to invest in any of the benchmark funds to hedge its obligations to plan participants (although it retained the option to do so) and that plan participants were only general creditors of the employer, and did not have the right to any amount held in a segregated account. *The Goldman Sachs Group, Inc*. (avail. Mar. 8, 2005). It is not clear, however, whether this no-action position will be applied by the SEC staff to other reference instruments that are based on the performance of § 3(c)(1) or § 3(c)(7) funds.

207 *But see* the discussion of monitoring resales under § 3(c)(7) of the Investment Company Act at § 15.06[1].

208 *See Alpha Finance Corp.* (avail. July 27, 1990) (response stated that the staff could not assure that it would not recommend enforcement action if, notwithstanding extensive transfer restrictions, more than 100 persons in the United States beneficially own the securities at any time).

209 § 2(a)(42) of the Investment Company Act.

210 SEC Release No. IC-8456 (Aug. 9, 1974); *see also Weiss, Peck & Greer Venture Associates II, L.P.* (avail. Apr. 10, 1990). *But see Horsley Keogh Venture Fund* (avail. Apr. 27, 1988) (taking the position that an interest that gives the right to name a new general partner constitutes a voting security).

211 *See, e.g.*, *Devonshire Capital Corp.* (avail. Feb. 15, 1976); *Pierce, Lewis & Dolan* (avail. Mar. 17, 1972).

212 The staff has taken a similar position where funds have common advisers and promoters. *Monument Capital Management, Inc.* (avail. July 12, 1990).

213 § 3(c)(7)(B) of the Investment Company Act; *see also Goodwin, Procter & Hoar* (avail. Feb. 28, 1997). *But see Washington Capital Joint Master Trust* (avail. Sept. 25, 2006) in which the staff, while noting the distinction in facts from *Coutts Global Fund* (avail. Apr. 11, 1994) in which sub-funds of an offshore "umbrella" trust were deemed to be separate issuers for purposes of § 3(c)(1), nonetheless granted no-action relief in the case of sub-funds of a domestic trust subject to ERISA that relied on various exceptions from the definition of "investment company," such as those set forth in §§ 3(c)(1), 3(c)(5) and 3(c)(7) of the Investment Company Act. In both cases, the assets and liabilities of each sub-fund in the trust were separate from those of any other sub-funds, and the ownership interests in the trust were composed of units representing interests in the property of a discrete sub-fund the assets of which could only be applied to discharge claims against that sub-fund and could not be applied to discharge claims against any other sub-fund.

214 *PBT Covered Option Fund* (avail. Feb. 17, 1979).

215 *PBT Covered Option Fund* (avail. Feb. 17, 1979); *see also Monument Capital Management, Inc.* (avail. July 12, 1990); *Rogers, Casey & Associates, Inc.* (avail. June 16, 1989). *But see Resolution Trust Corp.* (avail. July 18, 1991) (granting no-action relief where there would be materially different cash flows allocated to securities of various funds, notwithstanding that all funds had a single adviser); *Oppenheimer Arbitrage Partners, L.P.* (avail. Dec. 26, 1985) (granting no-action relief where funds had dissimilar portfolio risk/return characteristics, different investment objectives and different portfolio composition and were

designed for different classes of investors such that no reasonable investor would be qualified to invest in both funds); *Pasadena Investment Trust* (avail. Jan. 22, 1993) (granting no-action relief where a non-U.S. fund and a U.S. registered fund, as a result of the non-U.S. fund's offering and selling its securities outside the United States and investing substantially all of its assets in the U.S. registered fund, shared the same investment objectives and risk/return characteristics but created materially different investment opportunities for foreign and U.S. investors because of differing tax laws and other regulatory disparities).

216 *See, e.g.*, *Madison Park Investment Management* (avail. Mar. 4, 1986) (denying no-action relief where two funds that would use different broker-dealers had the same investment objectives and risk/return characteristics and portfolio composition, notwithstanding differences in investment strategy that could result from the transaction costs associated with each broker and the timing of the formation of each fund).

U.S. Regulation of the International Securities and Derivatives Markets, § 15.07, OTHER REGULATORY ISSUES FOR FOREIGN FUNDS

U.S. Regulation of the International Securities and Derivatives Markets
1 Edward F. Greene, Alan L. Beller, Edward J. Rosen, Leslie N. Silverman, Daniel A. Braverman, Sebastian R. Sperber, Nicolas Grabar & Adam E. Fleisher, U.S. Regulation of the International Securities and Derivatives Markets § 15.07 (11th and 12th Editions 2014-2017)
11th and 12th Editions

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Foreign funds seeking to make offers in the United States, and even to U.S. investors seeking to acquire interests in such funds in the secondary markets abroad, must also address other regulatory issues in addition to those arising under U.S. federal securities laws. For example, funds that trade futures and commodity options may be "commodity pools" within the meaning of the CEA, thus necessitating registration of the fund's managers as "commodity pool operators." [217]

Aside from issues pertaining directly to the fund's operation, a foreign fund must also take into account issues relevant to its targeted investors. Pension funds regulated under ERISA are subject to a variety of restrictions, certain of which, if not adequately addressed, may result in the foreign fund manager's being deemed to be a "fiduciary" and in the foreign fund assets becoming "plan assets" within the meaning of ERISA, thereby subjecting the foreign fund manager to the fiduciary standards imposed by ERISA and subjecting the assets of the foreign fund to the custody and prohibited transaction requirements of ERISA and the U.S. tax laws. The effects of U.S. federal income taxation on portfolio investment—principally the "passive foreign investment company," or "PFIC," rules—must also be considered in planning an offering targeted to U.S. investors.

[1] U.S. Pension Investment in Foreign Funds

ERISA does not prohibit investment by U.S. pension funds in the securities of foreign investment companies, including those denominated in currencies

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other than U.S. dollars. [218] Rather, each investment must be judged in light of ERISA's "prudent man" rule. [219]

The most significant ERISA provision that may affect foreign funds is that if investments by pension funds subject to ERISA and certain other types of investors in the aggregate equal or exceed 25% by value of any class of equity securities of the foreign fund, the assets of the foreign fund itself are likely to be treated as plan assets. In such a case, as discussed in more detail below, the application of ERISA to the assets of the foreign fund would have very significant consequences. [220]

ERISA has no specific requirements relating to investment in foreign securities except concerning their custody. Only foreign securities or, in certain limited circumstances, foreign currency may be held outside the United States, and then only if certain conditions are satisfied.

[a] The “Prudent Man” Rule

The legislative history of ERISA recognized that "investment in securities of foreign companies and governments have [sic] been and may well continue to be in the best interests of plan participants in appropriate circumstances and with proper safeguards." [221] The standard for judging a fiduciary's decision to invest in foreign securities is the same as that applied to any investment decision made by a fiduciary: a fiduciary must make the decision to invest in foreign securities "with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims." [222]

Although U.S. Department of Labor regulations interpreting the prudent man rule provide little objective guidance, they do provide that the prudent man rule will be satisfied with respect to an investment made by a fiduciary if the fiduciary has given "appropriate consideration" to all the facts and circumstances, given the scope of the fiduciary's investment duties, that the fiduciary knows or should know are relevant to the particular investment. [223] Among the considerations that might be appropriate in the context of a decision whether to

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invest in foreign securities are opportunities for increased return and diversification by investing in foreign securities, volatility of certain foreign equity markets, currency risks and hedging costs, tax implications, political risk, relative lack of disclosure regarding investments and lower levels of liquidity in certain foreign markets.

There is no limitation in ERISA regarding the maximum percentage of pension fund assets that may be invested in foreign securities. There is, however, a general rule that requires a pension fund manager to invest the fund's assets in a diversified manner so as to prevent the risk of large losses—the so-called diversification rule. [224] As with the prudent man rule, the diversification rule provides little objective guidance in determining the appropriate mix of foreign securities in a pension fund's portfolio.

[b] Plan Asset Regulations

Under regulations issued by the U.S. Department of Labor, as modified by § 3(42) of ERISA (the "Plan Asset Regulations"), the assets of a foreign fund or other entity in which an employee benefit plan subject to ERISA invests can, under certain circumstances, be deemed assets of the pension plan itself ("plan assets"). [225] The Plan Asset Regulations generally provide that when a “plan acquires an equity interest [226] in a foreign fund or other entity, the plan's assets include both the equity interest and an undivided interest in the underlying assets of the entity, unless it is established that: (i)(a) the equity interest acquired is a "publicly offered security" [227] or (b) although unlikely for reasons discussed in § 15.08 below, the equity interest acquired is a security issued by an investment company registered under the Investment Company Act, (ii) the entity is an "operating company," or (iii) equity participation in the entity by "benefit plan investors" does not equal or exceed 25% of the value of any class of equity securities of the entity (the "25% test"). [228] As a result, generally, unless a foreign fund

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is registered under the Investment Company Act, or qualifies as a "venture capital operating company" or a "real estate operating company," participation in the fund by benefit plan investors should be limited in order to avoid having assets of the fund considered "plan assets." [229] If the assets of the fund constitute plan assets, the whole panoply of ERISA's substantive fiduciary provisions would apply to the foreign fund. It is often difficult, if not impracticable, to comply with such provisions.

For purposes of the 25% test exception, a "benefit plan investor" is any of the following:

- any employee welfare benefit plan or employee pension benefit plan subject to the provisions of Title I of ERISA;
- any plan described in I.R.C. § 4975(e)(l) to which I.R.C. § 4975 applies, such as individual retirement plans ("IRAs") or Keogh plans; [230] and
- any entity whose underlying assets include plan assets by reason of a plan's investment in the entity (a "plan asset entity"). [231]

Benefit plan investors therefore include not only U.S. plans subject to ERISA, IRAs and Keogh plans, but also entities such as collective trusts, insurance company separate accounts and, in certain cases, general accounts and limited partnerships holding assets deemed to be plan assets.

Because of the Plan Asset Regulations, some foreign funds completely prohibit sales to benefit plan investors. Other funds strictly limit sales to benefit plan investors and include restrictions on subsequent transfers in order to ensure that the 25% test is not violated as a result of secondary market sales.

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Some foreign funds seek to qualify as venture capital operating companies ("VCOCs"). An entity is a VCOC if at least 50% of its assets (valued at cost) are invested in "venture capital investments" and the entity, in the ordinary course of its business, actually exercises "management rights" with respect to one or more of the operating companies in which it invests. [232] A "venture capital investment" is an investment in an operating company (other than another VCOC) as to which the investor obtains "management rights." An "operating company" generally is defined as an entity that is primarily engaged, directly or indirectly through majority-owned subsidiaries, in the production or sale of a good or service other than the investment of capital. [233] "Management rights" are contractual rights directly between the investor and an operating company to substantially participate in, or substantially influence the conduct of, the management of the operating company. In order to qualify as a VCOC, an entity must meet these requirements on the date it makes its first long-term investment and annually during an "annual valuation period." An entity cannot qualify as a VCOC before it makes its first investment in an operating company. Therefore, a manager of an investment fund seeking to qualify as a VCOC generally will not accept funds from plans until the closing of the fund's first investment in an operating company. [234]

The consequences of deeming the assets of a foreign investment company to be plan assets could potentially be severe. In addition to imposing general fiduciary standards, ERISA generally prohibits a broad range of transactions involving the assets of a plan subject to ERISA and persons having a specified relationship to the plan, such as advisers, brokers and others with whom a foreign fund would normally do business. [235] Many transactions undertaken in the ordinary course by a foreign fund would probably be prohibited. Under U.S. law, excise tax liability for "parties in interest" or "disqualified persons" to plans and civil liability for such plans' fund advisers and other "fiduciaries" could result from prohibited transactions. [236] The fact that private litigants can bring suit for fiduciary breaches, that indemnities for, and disclaimers of, breaches of fiduciary

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duty may be unenforceable and that such excise taxes could be imposed cause many foreign funds to take steps to avoid the applicability of ERISA. [237]

[c] Holding Plan Assets Outside the United States

ERISA prohibits a pension fund subject to ERISA from holding the indicia of ownership [238] of any securities outside the jurisdiction of the U.S. district courts unless held in a manner permitted by U.S. Department of Labor regulations. [239]

Under the regulations, only "foreign securities" (and, in limited cases, foreign currency) may be held outside the jurisdiction of the U.S. district courts. [240] There are three principal alternatives under which foreign securities or currency may be held outside the jurisdiction of the U.S. district courts: the asset manager alternative, the direct custody alternative or the indirect custody alternative.

Under the asset manager alternative, the pension fund's assets must be managed and controlled by a U.S. entity with a principal place of business within the United States that is a bank, insurance company or SEC-registered investment adviser that meets certain capital and regulatory requirements. [241] Under this alternative, the pension fund manager may prudently select any capable person, domestic or foreign, to act as a custodian of pension fund assets, regardless of whether that person is a qualifying bank, insurance company, broker or dealer.

Under the direct custody alternative, foreign securities may be held outside the jurisdiction of the U.S. district courts in the physical possession of a U.S.

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entity that is a bank or SEC-registered broker or dealer with a principal place of business in the United States and that meets certain capital requirements. [242]

Under the indirect custody alternative, foreign securities may be held outside the jurisdiction of the U.S. district courts by an SEC-registered broker or dealer in the custody of an entity designated by the SEC as a satisfactory control location [243] holding as agent for the broker or dealer, or by a U.S. bank in the custody of an entity that is a foreign securities depositary, a foreign clearing agency that acts as a securities depository, or a foreign bank, provided in each case that certain additional requirements are met. [244]

[2] U.S. Federal Income Tax Considerations

A foreign investment company that invests in U.S. securities will need to take steps to ensure that it will not become subject to U.S. federal income tax on a net income basis as a result of its activities in the United States. The foreign investment company will also need to consider whether U.S. withholding tax will be imposed on income it receives in respect of the U.S. securities and whether it will be required to withhold U.S. tax on distributions that it makes.

Additional U.S. tax considerations will arise if shares in the foreign investment company are marketed to U.S. investors. In that case, the U.S. shareholders of the foreign investment company may be subject to potentially adverse U.S. tax treatment under special rules that apply to U.S. shareholders of "passive foreign investment companies."

[a] Investing in U.S. Securities

[i] *U.S. Federal Income Tax*

To preserve investor returns, foreign investment companies are usually structured so that they will not be subject to significant foreign or U.S. net income taxes. Foreign taxes may be minimized by organizing the foreign investment company in a "tax haven" jurisdiction, such as the Cayman Islands, the Netherlands Antilles or Bermuda. Tax havens do not impose significant taxes on the net income of domestic corporations and usually do not impose withholding taxes on distributions of earnings to nonresident shareholders.

Income of a foreign investment company will not be subject to U.S. federal income tax on a net income basis if the company is not "engaged in trade or business within the United States." If the foreign investment company is so

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engaged, the net taxable income of the company that is "effectively connected" with the trade or business will be subject to U.S. federal income tax at the normal rates applicable to U.S. corporations and, upon distribution of the effectively connected earnings, the foreign investment company may be subject to a 30% U.S. tax under U.S. "branch profits tax." [245]

To encourage foreign investors to trade in the U.S. capital markets, the U.S. tax rules provide a "safe harbor" that generally exempts such investors from U.S. federal income tax. [246] Under the safe harbor rule, a foreign investment company will not be engaged in a U.S. trade or business as a result of its securities trading activities in the United States, and thus will not be subject to U.S. federal income tax as a result of such activities, if the company is not a "dealer" in securities. [247]

Additional U.S. tax considerations will be relevant if the foreign investment company invests in a partnership that is engaged in a U.S. trade or business. The U.S. tax rules attribute the U.S. trade or business of a partnership to its foreign partners, [248] and a foreign partner may be allocated a distributive share of the effectively connected income of the partnership. As a result, if a foreign investment company acquires an interest in such a partnership, the company's

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share of the income of the partnership (after taking into account allowable deductions connected to such income) generally will be subject to U.S. federal income tax. [249] In addition, partnership income allocable to the foreign investment company may be subject to a 30% U.S. tax under the U.S. "branch profits tax." [250] Even if the foreign investment company is not allocated any effectively connected income from the partnership, it will be obligated to file a U.S. federal (and possibly state and local) income tax return due to the fact that it is treated as engaged in a U.S. trade or business. The foregoing rules relating to investments in a U.S. partnership will not apply if the partnership is treated as a corporation for U.S. tax purposes because interests in the partnership are publicly traded. [251] An investment in such a partnership by a foreign investment company will be treated the same as an investment in stock of a U.S. corporation. Furthermore, the foregoing discussion generally assumes that the foreign investment company is itself treated as a corporation for U.S. tax purposes. If a foreign investment company instead is treated as a partnership for U.S. tax purposes, the applicable rules are somewhat different, although they generally raise the same issues.

Special U.S. tax considerations also apply if the foreign investment company invests in a "United States real property interest" ("USRPI"), such as stock of U.S. corporations whose assets consist primarily of U.S. real property. [252] A foreign investment company's gain from the disposition of a USRPI is treated as effectively connected income. Accordingly, such gains would be subject to U.S. federal income tax, and the company would be required to file a U.S. federal income tax return. However, stock that is regularly traded on an established securities market will not be treated as a USRPI if the foreign investment company did not hold more than 5% of such stock at any time during the five-year period ending on the date the stock is sold. [253] Stock in a "real estate investment trust" also will not be treated as a USRPI if either (i) the trust is majority owned by U.S. persons or (ii) the foreign investment company did not hold more than 10% of such stock at any time during the five-year period ending on the date the stock is sold. [254]

[ii] *U.S. Withholding Tax*

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Foreign investment companies that invest in stock or securities of U.S. issuers must also consider whether income from those investments will be subject to U.S. withholding taxes. Most U.S. source interest income from standard capital markets debt securities will qualify as "portfolio interest" that is exempt from U.S. withholding tax. [255] However, subject to certain other exemptions, the gross amount of dividends and other payments of "fixed or determinable annual or periodical" income, including interest that is not "portfolio interest," received by a foreign investment company from sources within the United States will be subject to U.S. withholding tax at the rate of 30%. [256] The tax is deducted and withheld from the payment by the U.S. payor and is not refundable. [257] The 30% rate for U.S. withholding tax may be reduced under an applicable U.S. income tax treaty (although the United States has not entered into such treaties with the tax haven jurisdictions where many foreign investment companies are organized). [258]

Because U.S. withholding taxes can significantly reduce a foreign investment company's returns from investments in the United States, potential U.S. withholding taxes must be considered in connection with each such investment. Many foreign investment companies have established investment guidelines that help them to determine efficiently whether income from proposed investments will be subject to U.S. withholding taxes.

A detailed discussion of the U.S. tax rules applicable to foreign investors in securities of U.S. issuers is beyond the scope of this book. However, the most important exemptions from U.S. withholding tax other than the "portfolio interest" exemption that may apply include interest paid on a bank deposit in the United States, [259] discount on an obligation with a maturity of 183 days or less

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from the date of original issue [260] and capital gains realized by a foreign corporation. [261]

In 2010, an additional level of U.S. withholding tax was enacted under the so-called Foreign Account Tax Compliance Act ("FATCA") rules to deter U.S. taxpayers from hiding foreign assets and income from the Internal Revenue Service ("IRS"). [262] In general, FATCA imposes a 30% withholding tax on all dividends, interest and other fixed or determinable annual or periodical payments from a U.S. source, and on the gross proceeds from the sale or disposition of any assets that can produce U.S. source dividends or interest, made to, or received by, a "foreign financial institution" ("FFI"), unless the FFI agrees to report information about its U.S. direct and indirect investors to the IRS and to withhold U.S. tax on distributions to investors who do not comply with the FATCA rules. [263] The definition of an FFI includes a foreign bank and a foreign entity that, as a substantial portion of its business, holds financial assets for the account of others, or that is engaged primarily in the business of investing or trading in securities or other financial assets. [264] Based on this broad definition, most foreign investment companies will be treated as FFIs.

In general, in order to avoid the 30% FATCA withholding tax, a foreign investment company that is an FFI will be required to enter into an agreement with the IRS pursuant to which it generally will be required to identify and report to the IRS information with respect to direct and indirect U.S. investors, withhold 30% tax on U.S. source payments to investors and other FFIs that refuse to comply with FATCA's requirements, and, in some cases, close accounts with respect to which reporting is not permitted. [265] Less onerous rules will apply if the foreign investment company satisfies the IRS that it has no U.S. investors or if it does not qualify as an FFI. [266] Regulations also impose detailed diligence requirements on FFIs; however, these are satisfied in many cases by collecting

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U.S. tax forms (*e.g.*, Form W-8BEN, Form W-8BEN-E, Form W-9) from investors. [267] As a result, investment companies should generally expect to collect U.S. tax forms from their investors, and provide such forms to their counterparties. The United States has entered into intergovernmental agreements ("IGAs") with many jurisdictions to implement FATCA. Most IGAs require FFIs in a particular jurisdiction to report account holder information to local tax authorities, who in turn provide such information to the IRS.

Withholding on payments to non-compliant investors commenced on July 1, 2014 in respect of dividends, interest and other fixed or determinable annual or periodical payments, and will commence in 2019 with respect to gross proceeds on the sale or disposition of U.S. financial assets. [268]

[b] Tax Consequences for U.S. Shareholders

U.S. shareholders of a corporation generally are not subject to U.S. tax on corporate earnings until those earnings are distributed to them as dividends. However, under complex rules that apply to U.S. holders of equity securities of a "passive foreign investment company" ("PFIC"), U.S. holders of equity securities of most foreign investment companies are denied the benefits of tax deferral on undistributed earnings. [269] A foreign investment company will be a PFIC if it is a foreign corporation and either a substantial portion of its assets consists of stock or securities or its income is mainly derived from stock or securities. [270] Under these rules, most foreign investment companies will be PFICs. Some foreign entities that are inadvertent investment companies for purposes of the Investment Company Act may not be PFICs, but a case-by-case evaluation is required.

The PFIC rules provide several alternative mechanisms for eliminating tax deferral on the undistributed earnings of a PFIC. If neither of the elections described below is made, "excess distributions" in respect of the PFIC shares and

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gain realized on the sale of the PFIC shares will be allocated over the shareholder's holding period and the U.S. shareholder's tax liability (*i.e.*, the applicable rate of tax and interest charges for deemed underpayments of tax) will be determined accordingly. [271]

Alternatively, if a "qualified electing fund" election is made, the U.S. shareholder will be required to include in gross income for each taxable year of the PFIC its share of the undistributed earnings of the PFIC. [272] The U.S. shareholder may, subject to an interest charge, elect to defer the payment of taxes on undistributed PFIC earnings included in income. [273] To enable its U.S. shareholders to make a qualified electing fund election, a foreign investment company whose potential investors include U.S. investors generally must separately calculate its income in accordance with U.S. tax principles and make this information available to its U.S. shareholders or provide its U.S. shareholders with sufficient access to its books and records to permit them to perform the required calculations. [274]

A third option is available generally for a U.S. shareholder of PFIC stock that is "marketable." [275] This option permits such a shareholder to elect to use a mark-to-market approach whereby it includes any increase or, to the extent of net prior mark-to-market inclusions, any decrease in the fair market value of its PFIC stock as of the close of the taxable year as ordinary income or loss. [276] Stock in a PFIC is marketable if it is regularly traded on a U.S. securities exchange or regulated foreign exchange satisfying certain specified requirements, or if the PFIC offers for sale or has outstanding stock that is redeemable at its net asset value in a manner similar to U.S.-registered investment companies. [277]

Because adverse tax rules apply to U.S. shareholders of a PFIC, equity securities of a foreign investment company may not be an attractive investment for taxable U.S. investors. However, U.S. pension funds and other tax-exempt investors should not be affected by the PFIC rules. Offering materials for equity securities of a foreign investment company that will be offered in the United States generally should indicate that the foreign investment company will be a PFIC and that U.S. investors will be subject to adverse U.S. tax rules applicable to U.S. shareholders of a PFIC.

[3] Anti-Money Laundering Compliance Obligations

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[a] Registered Investment Companies

Registered investment companies that operate as open-end investment companies, or "mutual funds," are required under the Bank Secrecy Act ("BSA") and the Financial Crimes Enforcement Network's ("FinCEN") implementing regulations thereunder to develop and implement an anti-money laundering program pursuant to § 352 of the PATRIOT Act. [278] In order to implement an anti-money laundering program under FinCEN's rules, a mutual fund is required to adopt written policies and procedures reasonably designed to ensure that it not be used to launder money. The mutual fund is also required to provide for periodic independent testing of the program, designate an anti-money laundering compliance officer and provide ongoing training to employees.

The BSA imposes additional requirements on mutual funds, many of which are similar to the applicable requirements for broker-dealers, discussed in § 14.07[4]. For example, mutual funds are required under § 326 of the PATRIOT Act to maintain a CIP (customer identification program) as part of their broader anti-money laundering program. [279] The CIP requirements for mutual funds are similar to the requirements summarized in § 14.07[4][d] for broker-dealers. Additionally, like broker-dealers, mutual funds are among the financial institutions required to identify and verify the identity of the beneficial owners of their legal entity customers under FinCEN's final customer due diligence rule issued in May 2016, the requirements of which are summarized in § 14.07[4][e]. [280] Mutual funds also are subject to FinCEN's information sharing rule, [281] which is summarized in § 14.07[4][f] as it relates to broker-dealers, and its private banking and correspondent account due diligence and enhanced due diligence rules, which are similarly summarized in § 14.07[4][g]. [282]

Mutual funds are also subject to reporting and record-keeping requirements, including a requirement to file suspicious activity reports with FinCEN

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based on criteria that are similar to the criteria that must be applied by broker-dealers, as described in § 14.08[3][a]. [283]

[b] Unregistered Investment Companies

In November 2008, FinCEN withdrew proposed rules that would have required certain types of unregistered investment companies, including certain hedge funds, real estate investment trusts, commodity pools and other investment funds and vehicles, to develop and implement an anti-money laundering program pursuant to § 352 of the PATRIOT Act. [284] In August 2015, FinCEN released proposed rules, which are summarized in § 16.15, that would impose AML compliance obligations on registered investment advisers pursuant to the BSA. [285] Due to the Dodd-Frank Act's expansion of the scope of investment advisers required to register with the SEC, the proposed rules would apply to many investment advisers to unregistered investment companies, such as hedge funds, private equity funds and other private funds, and would achieve similar coverage of the asset management industry as the proposed rules for unregistered investment companies withdrawn in 2008. [286]

Footnotes

217 Security futures products are defined both as securities and as futures contracts. *See* U.S. REGULATION OF THE INTERNATIONAL SECURITIES AND DERIVATIVES MARKETS TWELFTH EDITION, DERIVATIVES MARKETS, § 2.16[5].

218 *See* H.R. Rep. No. 93-1280, 93d Cong., 2d Sess. 306, *reprinted in* 1974 U.S.C.C.A.N. 5038, 5086.

219 § 404(a)(1)(B) of ERISA.

220 § 3(42) of ERISA; Labor Reg. § 2510.3-101(a)(2)(ii) and (f) under ERISA; *see* § 15.07[1][b]. Additionally, in April 2016, the Department of Labor issued a final rule defining who is a "fiduciary" of an employee benefit plan under ERISA. *See* § 14.07[1][a].

221 H.R. Rep. No. 93-1280, 93d Cong., 2d Sess. 306, *reprinted in* 1974 U.S.C.C.A.N. 5038, 5086.

222 § 404(a)(1)(B) of ERISA.

223 Labor Reg. § 2550.404a-1(b)(2)(i) under ERISA.

224 § 404(a)(1)(C) of ERISA.

225 § 3(42) of ERISA; Labor Reg. § 2510.3-101(a)(2) under ERISA.

226 "Equity interest" means any interest in an entity other than an instrument that is treated as indebtedness under applicable local law and that has no substantial equity features. Labor Reg. § 2510.3-101(b)(1) under ERISA.

227 "Publicly offered security" means a security which is: (i) part of a class of securities owned by more than 100 investors independent of the issuer and each other, (ii) freely transferable, which is determined by a facts and circumstances test, and (iii) either part of a class of securities (1) registered under § 12(b) or § 12(g) of the Exchange Act or (2) acquired by the plan in a U.S. public offering and subsequently and timely registered under § 12 of the Exchange Act. Labor Reg. § 2510.3-101(b)(2) under ERISA.

228 § 3(42) of ERISA; Labor Reg. § 2510.3-101(a)(2) and (f) under ERISA. In determining the ownership percentage of benefit plan investors, any interests held by a person who has discretionary authority or control with respect to the assets of the foreign fund or other entity or any person who provides investment advice for a fee (direct or indirect) with respect to any such assets or any affiliate of such a person is excluded. The 25% test must be met each time an acquisition of any equity interest in the foreign fund or other entity is made.

229 The exception for publicly offered securities is available only for securities publicly offered in the United States and/or registered under the Exchange Act. Other foreign entities that are inadvertent investment companies for purposes of the Investment Company Act may nonetheless be operating companies under the Plan Asset Regulations, but an evaluation must be made on a case-by-case basis.

230 An IRA is a written trust or custodial account to which eligible individuals may make cash contributions up to certain limits, with the benefit of tax-deferred buildup of income available for retirement. A Keogh plan is a qualified retirement plan established for the benefit of a self-employed individual.

231 § 3(42) of ERISA. With respect to a plan asset entity, its investment will be counted as an investment by a benefit plan investor only to the extent its own equity interests are held by benefit plan interests (*i.e.*, its

investment will be pro rated between benefit plan investor money and non-benefit plan investor money by reference to the proportion of its own equity interests held by benefit plan investors and non-benefit plan investors).

232 Labor Reg. § 2510.3-101(d) under ERISA.

233 Labor Reg. § 2510.3-101(c) under ERISA.

234 A "real estate operating company" ("REOC") is similar to a VCOC except that it is designed to invest in real property. A REOC must invest at least 50% of its assets in real estate that is managed or developed and with respect to which the entity has the right to substantially participate directly in the management or development activities. The entity must be engaged directly in real estate management or development activities in the ordinary course of its business. Labor Reg. § 2510.3-101(e) under ERISA.

235 §§ 406 and 3(14) of ERISA; *see also* I.R.C. § 4975(a), (b), (c) and (e)(2).

236 I.R.C. § 4975; §§ 409 and 502(1) of ERISA; *see also Harris Trust and Savings Bank v. Salomon Smith Barney Inc.*, 530 U.S. 238 (2000).

237 In addition, if the assets of the foreign fund are deemed to be plan assets, the rules regarding holding plan assets outside the United States discussed in § 15.07[1][c] would apply to all of the assets of the foreign fund, which, in the case of a fund having assets other than securities or currency, would prove unworkable.

238 The term "indicia of ownership" means the documents that represent the pension fund's ownership interest, *e.g.*, a stock certificate, a bond or, according to a Department of Labor interpretation, an ADR. The latter means that if an ADR is maintained within the jurisdiction of the U.S. district courts, the underlying foreign security need not be maintained within the jurisdiction of the U.S. district courts. Preamble to Labor Reg. § 2550.404b-1 under ERISA, 42 Fed. Reg. 54,122, 54,122 (Oct. 4, 1977); Department of Labor Advisory Opinions 75-80 (Feb. 13, 1975) and 87-03A (May 5, 1987).

239 § 404(b) of ERISA.

240 Labor Reg. § 2550.404b-1(a)(1) under ERISA. "Foreign securities" include (i) securities issued by a person (other than an individual) that is not organized under the laws of the United States or any state and that does not have its principal place of business within the United States, (ii) securities issued by a foreign government or its instrumentalities and (iii) securities issued by a person (other than an individual), the principal trading market for which is outside the jurisdiction of the U.S. district courts. Foreign currency may only be held outside the jurisdiction of the U.S. district courts solely as an incident to the purchase, sale or maintenance of foreign securities.

241 Labor Reg. § 2550.404b-1(a)(2)(i) under ERISA.

242 Labor Reg. § 2550.404b-1(a)(2)(ii)(A) under ERISA.

243 *See* § 14.07[1][b], Note 309.

244 Labor Reg. § 2550.404b-1(a)(2)(ii)(B) and (C) under ERISA.

245 I.R.C. §§ 882(a)(1) and 884.

246 The safe harbor is nonexclusive and, in certain cases, a foreign investment company that does not meet all of the requirements for "safe harbor" treatment may nevertheless not be engaged in a U.S. trade or business under the relevant case law. *See, e.g.*, *Higgins v. Commissioner*, 312 U.S. 212 (1941). For example, a foreign investment company generally will not be engaged in a U.S. trade or business where it has a foreign-based investment adviser and no investment discretion is given to any agent in the United States at any time, no investment decisions are made in the United States and the investment company has no office or fixed place of business in the United States through which, or at the direction of which, transactions are effected.

247 I.R.C. § 864(b)(2)(A)(ii). The safe harbor applies to securities transactions effected by employees of the foreign investment company or through a U.S. broker, commission agent, custodian or other agent, whether or not the employee or agent has discretionary authority. The number of transactions effected in the United States is irrelevant. *See* Treas. Reg. § 1.864-2(c)(2)(i). A foreign investment company will be a dealer if it is regularly engaged in purchasing stocks or securities and selling them to customers. Treas. Reg. § 1.864-

2(c)(2)(iv). Under this rule, very few foreign investment companies will be considered to be dealers. Foreign investment funds may rely on a similar safe harbor for commodities trading activities, subject to certain additional requirements. I.R.C. § 864(b)(2)(B)(ii).

Certain investment-like activities of a foreign investment company may not qualify for the safe harbor. For example, originating loans to U.S. borrowers rather than purchasing loans as an investor may result in a foreign investment company being engaged in a U.S. trade or business. *See* I.R.S. A.M. 2009-010 (Sept. 22, 2009). Furthermore, a foreign investment company that invests in U.S. mortgages or mortgage-backed securities may be treated as engaged in a U.S. trade or business if it purchases distressed mortgages with a view to negotiating a workout with mortgagors or if it forecloses on a mortgage and as a result holds a direct interest in U.S. real estate.

248 I.R.C. § 875(1).

249 Under I.R.C. § 1446, a partnership that is engaged in a U.S. trade or business is required to withhold taxes in respect of a foreign partner's share of the partnership's effectively connected income. Special rules apply to publicly traded partnerships that are not treated as corporations for U.S. tax purposes. *See* Treas. Reg. § 1.1446-4.

250 *See* I.R.C. § 884.

251 *See* I.R.C. § 7704.

252 *See* I.R.C. § 897.

253 I.R.C. § 897(c)(3). Interests in publicly traded partnerships and trusts are subject to rules similar to those that apply to publicly traded corporations. *See* Treas. Reg. § 1.897-1(c)(2)(iv).

254 *See* I.R.C. § 897(h)(2), (k)(1). In addition, stock in a "real estate investment trust" will not be treated as a USRPI if held by certain publicly traded foreign investment corporations. *See* I.R.C. § 897(k)(2).

255 The "portfolio interest" exemption applies to interest paid on debt obligations issued after July 18, 1984. Interest will not qualify as "portfolio interest" if the foreign investment company owns, directly or indirectly, 10% or more of the voting stock of the issuer of the debt obligation. I.R.C. § 881(c)(3)(B). The portfolio interest exemption also is subject to certain other limitations.

256 I.R.C. § 881(a)(1). Whether investment income is considered to be from sources within the United States for U.S. withholding tax purposes is determined under special rules that vary depending upon the particular type of income received. In 2017, similar withholding rules will apply to payments on equity derivatives and other equity-linked instruments that are determined by reference to dividends from sources within the United States. *See* I.R.C. § 871(m).

257 I.R.C. § 1442(a).

258 A foreign investment company may be able to claim benefits on behalf of investors under a tax treaty with their home jurisdiction if such jurisdiction treats the foreign investment company as a pass-through entity such that individual investors are required to include their allocable share of income on their income tax returns and the investors would otherwise qualify for the benefits of such tax treaty if they had earned this income directly. Treas. Reg. § 1.894-1(d).

259 I.R.C. §§ 881(d) and 871(i)(2)(A). In order for the exemption to apply, interest received on the bank deposit must not be effectively connected with the conduct of a trade or business within the United States.

260 I.R.C. § 871(g)(1)(B)(i).

261 Under I.R.C. §§ 865(a)(2) and 865(g)(1)(B), capital gains of a foreign corporation generally will not be U.S. source income and thus will not be subject to U.S. withholding tax under I.R.C. § 881(a)(1). *See also* Treas. Reg. § 1.1441-2(a)(3), which states that gain from the sale of property is not fixed or determinable annual or periodical income.

As discussed above, special rules apply to gains realized on the sale of a ("USRPI"). *See* I.R.C. §§ 897 and 1445.

262 FATCA, originally titled the Foreign Account Tax Compliance Act, was enacted as part of the Hiring

Incentives to Restore Employment Act of 2010, Pub. L. No. 111-147 124 Stat. 71 (2001) (the "HIRE Act"). The FATCA rules are located in I.R.C., Chapter 4 (§§ 1471-1474) and the Treasury Regulations promulgated thereunder.

263 I.R.C. §§ 1471 and 1473(1)(A).

264 I.R.C. §§ 1471(d)(4) and 1471(d)(5).

265 *See* Treas. Reg. §§ 1.1471-2, 1.1472-1.

266 I.R.C. § 1471(b)(2) (FFI with no U.S. investors); I.R.C. § 1472(b) (foreign investment company that is not an FFI).

267 Treas. Reg. § 1.1471-3(c).

268 IRS Notice 2015-66, 2105-41 I.R.B. 541 (Sept. 18, 2015). However, payments on debt obligations issued prior to January 1, 2014 are generally not subject to FATCA withholding. Treas. Reg. § 1.1471-2(b). Debt obligations issued prior to the date six months after final regulations implementing gross proceeds withholding are similarly exempted from FATCA withholding on gross proceeds from their sale or disposition. Treas. Reg. § 1.1471-2(b)(i)(3).

269 *See* I.R.C. §§ 1291–98. Undistributed earnings of a foreign investment company may also be taxed to its U.S. shareholders under the rules of the I.R.C. relating to controlled foreign corporations (I.R.C. §§ 951–65). In most cases, however, a foreign investment company will not be a controlled foreign corporation. A foreign investment company will not be a controlled foreign corporation unless, on any day during its taxable year, more than 50% of the voting power or value of its stock is owned by U.S. persons that own (directly or indirectly) 10% or more of the voting power of the corporation.

270 I.R.C. § 1297(a).

271 I.R.C. § 1291.

272 I.R.C. § 1293.

273 I.R.C. § 1294.

274 The rules for making a qualified electing fund election are specified in I.R.C. § 1295 and Treas. Reg. § 1.1295-1.

275 I.R.C. § 1296.

276 I.R.C. § 1296(a). Losses are allowable only to the extent of net mark-to-market gains previously included by the shareholder with respect to such stock. I.R.C. § 1296(a)(2). Additionally, corresponding adjustments are made to a shareholder's tax basis in its PFIC stock to the extent of any income or loss included by the shareholder. I.R.C. § 1296(b).

277 I.R.C. § 1296(e); Treas. Reg. § 1.1296-2(d).

278 *See* 31 U.S.C. § 5318(h)(1); 31 C.F.R. § 1024.210.

279 *See* 31 C.F.R. § 1024.220 (Treasury); 17 C.F.R. § 270.0-11 (SEC); *see also* SEC, Division of Investment Management, Questions and Answers Regarding the Mutual Fund [CIP] Rule (31 C.F.R. § 103.131) (Aug. 11, 2003).

280 *See* Final CDD Rule, 81 Fed. Reg. 29,397, 29,409 (May 11, 2016); 31 C.F.R. § 1010.230.

281 *See* 31 C.F.R. §§ 1024.500–1024.540.

282 *See* 31 C.F.R. §§ 1024.600–1024.630; *see also* Letter from Investment Company Institute to FinCEN (Feb. 3, 2006) (requesting concurrence that § 312 does not apply to accounts opened by U.S. financial institutions with mutual funds for the purpose of effecting fund share transactions cleared and settled through the National Securities Clearing Corporation Fund/SERV system, even if the NSCC member firm's customer is a non-U.S. financial institution).

283 *See* 31 C.F.R. §§ 1024.300–1024.410; *see also* FinCEN, Frequently Asked Questions: SAR Requirements for Mutual Funds (Oct. 4, 2006).

284 *See* 67 Fed. Reg. 60,617 (Sept. 26, 2002), *withdrawn* 73 Fed. Reg. 65,568 (Nov. 4, 2008).

285 *See* Anti-Money Laundering Program and Suspicious Activity Report Filing Requirements for Registered Investment Advisers, 80 Fed. Reg. 52,680 (Sept. 1, 2015).

286 *See* Anti-Money Laundering Program and Suspicious Activity Report Filing Requirements for Registered Investment Advisers, 80 Fed. Reg. 52,680, 52,682 (Sept. 1, 2015).

U.S. Regulation of the International Securities and Derivatives Markets, § 15.08, PROSPECTS FOR U.S. PUBLIC OFFERINGS BY FOREIGN FUNDS

U.S. Regulation of the International Securities and Derivatives Markets
1 Edward F. Greene, Alan L. Beller, Edward J. Rosen, Leslie N. Silverman, Daniel A. Braverman, Sebastian R. Sperber, Nicolas Grabar & Adam E. Fleisher, U.S. Regulation of the International Securities and Derivatives Markets § 15.08 (11th and 12th Editions 2014-2017)
11th and 12th Editions

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Section 7(d) of the Investment Company Act prohibits a public offering in the United States by a foreign investment company without an SEC order permitting its registration. [287] Such an order must be based on a finding that it is legally and practically feasible to enforce the Investment Company Act against the foreign investment company and that allowing the foreign investment company to register is consistent with the public interest and protection of investors. [288]

As a practical matter, the standard mandated by § 7(d) has proven exceptionally difficult to meet, [289] and few entities have succeeded in obtaining

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relief. [290] Indeed, SEC practice under § 7(d) has proven to be little more than a series of unsuccessful attempts to reconcile the statutory standard of § 7(d) to the demands of an international market.

Although, with the exception of Rule 7d-1 under the Investment Company Act, the SEC has proceeded on a case-by-case basis under § 7(d), it has provided some guidance as to factors relevant to its disposition of applications for relief. For many years, these guidelines were in fact based on Rule 7d-1. [291] Rule 7d-1 provides class relief under § 7(d) for Canadian management investment companies, on order of the SEC upon application, if the conditions of the rule are satisfied. While the SEC stated that the adoption of the rule was a recognition of the "high degree of comity that has prevailed between …[the United States] and Canada, the existing treaties, the proximity of the two countries, their joint heritage of the common law, and the essential similarity of statutes and law relating generally to corporations and the rights of stockholders," [292] the conditions of the rule in fact do little to recognize or accommodate differences between Canadian and U.S. securities laws. [293] Those conditions include, for example, requirements that a majority of the board of directors of the company be U.S. citizens of whom a majority are resident in the United States, that the company's charter or other constituent documents contain all of the substantive provisions of the Investment Company Act, which must be enforceable by the company's shareholders, and that all of the assets of the company be maintained in the United States. The rule requires, in effect, that the company be a U.S. investment company in all respects other than the location of its domicile. [294]

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Even subsequent to the adoption of Rule 7d-1 and the promulgation of the SEC's guidelines, few Canadian companies—and even fewer non-Canadian companies—sought or were granted the right to register under the Investment Company Act. [295] Not only have the requirements of the rule and the guidelines themselves been burdensome, but they also often conflict irremediably with local law applicable to a foreign investment company. In one well-known example—the attempt by the German company, Union-Investment-Gesellschaft mbH ("UI"), to register one of its funds, Unifonds, under § 7(d)—the Investment Company Act's terminology alone presented insurmountable obstacles. Whereas the Investment Company Act's definitions of "bank," "broker" and "underwriter" are derived from U.S. regulatory schemes that clearly separate these functions, under German law Unifonds was able to engage in banking, brokerage and underwriting activities. The consequences of the distinctions under the Investment Company Act are understood to have made compliance by UI and Unifonds with, for example, the requirements for independent members of the board of directors of UI and the restrictions imposed by the Investment Company Act on affiliated transactions uncertain at best. Nevertheless, after two years of negotiations, Unifonds reached agreement with the SEC as to the manner of its compliance with the provisions of the Investment Company Act, and the SEC finally published the Unifonds application for public comment. The publication drew objections from the Investment Company Institute—the most important of the investment company industry groups—which sought a public hearing as to the standards of § 7(d) and Unifonds's proposed compliance with the Investment Company Act. The prospects of such a hearing, which would likely have been lengthy and highly adversarial, prompted Unifonds to withdraw its application from consideration altogether.

The significance of these conflicts and the impediment posed by § 7(d) of the Investment Company Act to the internationalization of the securities markets have been repeatedly acknowledged by the SEC. Long before the issuance of the Concept Release, the SEC specifically requested public comment concerning appropriate standards for permitting increased access by foreign investment companies to the U.S. public market without sacrificing important concerns for investor protection. [296] In the wake of commentary that not only did not suggest

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any uniform solution to the difficult standard posed by § 7(d), but further highlighted the variety and number of obstacles encountered by foreign investment companies attempting to meet that standard, [297] the SEC determined to continue its historical practice of addressing registration of foreign investment companies on a case-by-case basis. The SEC nevertheless outlined certain conditions it would consider prerequisites to permitting registration of a foreign investment company, including that the company have a minimum three-year operating history, with at least $50 million in net assets at registration and $25 million at the time of any offering in the United States, and that the company undertake to limit U.S. investment to 50% of its total outstanding shares at the time of sale. [298] The SEC also imposed limitations on the portfolio investments of foreign companies seeking registration: a company must maintain at least 60% of the value of its portfolio in securities of issuers organized in its home country or 75% in securities of non-U.S. issuers. [299]

These additional guidelines stimulated so little activity under § 7(d) that in 1983 the SEC abandoned its efforts to formulate workable standards under § 7(d) and formally recommended that foreign investment companies consider forming a separate U.S.-domiciled company for purposes of raising capital in the U.S. public market. [300] The "mirror fund" approach—that is, the establishment of a separate U.S. registered investment company to be offered in the United States to invest in foreign securities that "mirrors" a non-U.S. fund offered outside the United States—effectively enables a foreign adviser to offer in the United States

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approximately the same product it offers outside the United States. However, the operations of the U.S. fund must be conducted within the framework of the Investment Company Act. In a 1996 no-action letter, the staff permitted the "bunching" of trades by a non-U.S. fund and its U.S.-registered mirror fund. [301] This bunching of trades and the subsequent allocation of proceeds was designed to lessen the trading inefficiencies of operating two separate funds.

The SEC staff's comprehensive review of the Investment Company Act in 1990 generated renewed interest in clarifying and ameliorating the operation of § 7(d). Among the staff's recommendations included in the 1992 Report was a call for legislative action to replace the standard imposed by § 7(d) with guidelines that would permit the SEC greater discretion in approving exemptive applications by foreign funds. The staff's proposed amendments would have authorized the SEC upon application to permit "operating foreign investment companies" [302] to make a U.S. public offering of their securities or otherwise to use U.S. jurisdictional means to offer or sell their securities, *if* (i) the SEC determines that "by reason of special circumstances or arrangements, it is both legally and practically feasible effectively to enforce" the Investment Company Act against the applicant and (ii) the SEC and the analogous authority in the domicile of the investment company have executed a "memorandum of understanding" providing for "regulatory cooperation and mutual recognition of investment company regulation by that country and the United States." [303]

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The staff's recommendations are unlikely to yield significant benefits for foreign funds. First, the staff proposed to retain the statutory standard required to be satisfied to receive an exemption that is currently provided in § 7(d). This standard has to date been the principal impediment to U.S. registration of foreign funds since it requires either that the foreign fund include all of the provisions of the Investment Company Act as part of its charter or that the fund make a detailed showing as to the comparability of local regulation to the Investment Company Act's requirements in the context of the fund's proposed activities. Moreover, this showing must be made separately by each applicant under § 7(d). The deficiencies of this approach have been amply demonstrated by the inability of all but a handful of foreign funds to make a U.S. public offering of their securities.

In addition, the staff added a requirement that had not previously been suggested for a memorandum of understanding with the jurisdictions in which acceptable funds are organized. This could provide a further obstacle to the introduction of foreign funds into the United States. On the other hand, if the staff were to make an otherwise workable proposal for the introduction of foreign funds into the United States, it is possible that the requirement for a memorandum of understanding could be satisfied in many jurisdictions.

Any foreign fund seeking authorization to register under the Investment Company Act would generally also require relief from certain of the Investment Company Act's provisions that may be inconsistent with the fund's home-country regulation. The staff's proposed amendments to § 7(d) would also authorize the SEC by rule or order to exempt any operating foreign investment company from any provision of the Investment Company Act, upon findings that (i) the exemption is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the Investment Company Act, (ii) the "laws under which such company operates provide protections for investors that serve the same purposes as the protections provided by the provisions of [the Investment Company Act] from which exemption is requested or that specific conditions agreed to by the company provide such investor protections," and (iii) the company is not operated for purposes of evading Investment Company Act regulation. This approach would apparently replace, in the case of foreign funds, the existing exemptive procedure under § 6(c) of the Investment Company Act that requires that the SEC make only the findings described in clause (i) above. [304] The additional showing called for by the SEC's proposed amendments would likely entail—as in the case of registration orders—a detailed analysis of the comparability of local and U.S. investment company regulation. Although in the 1992 Report the SEC acknowledged that "the foreign regulatory system need not be identical to the provisions from which exemption is requested," [305] the staff stated that the SEC would need to find that

> the foreign law adequately addresses the same regulatory concerns and serves essentially the same purposes….In making that finding, the [SEC] could consider the different regulatory requirements, customs, investment company business practices, and overall investment company regulatory framework in the jurisdiction in which the fund is organized. [306]

It is difficult to imagine how the revised standard, which appears only to increase the demonstrative burden of applicants while limiting the existing authority of the SEC under § 6(c) of the Investment Company Act, would expand the number of foreign funds able to access the U.S. public market. Indeed, given the SEC's authority under § 6(c), it is difficult to imagine why a second standard is at all necessary or desirable in the case of foreign funds, much less what role § 6(c) might play for those funds if the staff's recommendations were implemented. In this respect, the staff's proposal was in sharp contrast to an earlier SEC proposal to amend § 7(d) of the Investment Company Act. Among the conditions to the SEC's exemptive authority under that proposal was a finding that "compliance with the provision [for which exemption was requested] would be unduly burdensome because the company was organized or otherwise created under foreign law and invested primarily in foreign securities." [307] The ability of the SEC to consider the "burdens" of compliance with the Investment Company Act was criticized by many as providing an unfair advantage to foreign funds [308] and was expressly rejected by the staff in the 1992 Report. [309] If the universe of foreign funds operating in the United States is to expand, it is nevertheless this authority to weigh the relative benefits and burdens of compliance with the Investment Company Act that must be accorded to the SEC—a one-sided approach focusing exclusively on the benefits of U.S. regulation will, virtually by definition, fail to accommodate the often irreconcilable differences between U.S. and foreign regulators. Recent comments by the staff on opening the U.S. market to non-U.S. funds have focused on the ability of non-U.S. advisers to manage funds incorporated in the United States and not on increasing

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opportunities for non-U.S. funds. [310] Until the SEC takes any definitive action in this field, the guidelines provided in Rule 7d-1 under the Investment Company Act appear to be the best guidance available for the few companies that may seek relief under § 7(d). [311]

Footnotes

287 *See* § 15.06.

288 *See* § 7(d) of the Investment Company Act.

289 *See* SEC Release No. IC-8596 (Dec. 2, 1974); *see also* SEC Release No. IC-13691 (Dec. 23, 1983).

290 *See, e.g.*, *ASA Ltd.*, SEC Release Nos. IC-2739 (July 3, 1958) (notice of application) and IC-2756 (Aug. 13, 1958) (Order); *St. John D'el Rey Mining Company, Ltd.*, SEC Release Nos. IC-7861 (June 12, 1973) (notice of application) and IC-7885 (June 29, 1973) (Order); *Pan Australian Fund Ltd.*, SEC Release Nos. IC-7795 (Apr. 30, 1973) (notice of application) and IC-8028 (Oct. 10, 1973) (Order); *First American-Australian Investors Ltd.*, SEC Release Nos. IC-6460 (Apr. 15, 1971) (notice of application) and IC-6517 (May 12, 1971) (Order): *Worldwide Fund Ltd.*, SEC Release Nos. IC-3318 (Aug. 25, 1961) (notice of application) and IC-3327 (Sept. 18, 1961) (Order).

291 SEC Release No. IC-8959 (Sept. 26, 1975).

292 SEC Release No. IC-1945 (Jan. 28, 1954).

293 The difficult standard of § 7(d) has also resulted in the exclusion of foreign investment companies from other advantageous securities law developments. For example, the multijurisdictional disclosure system between the United States and Canada, discussed in Chapter 13, is not available for any entity subject to registration under the Investment Company Act.

294 Rule 7d-1 under the Investment Company Act also requires that each officer, director, investment adviser and principal underwriter for the company agree in writing to comply with the company's charter or other constituent documents and that failure to comply with that agreement will constitute a violation of the order issued by the SEC pursuant to Rule 7d-1. The company and each of its nonresident officers, directors and investment advisers must also agree to appoint the company's U.S. custodian as agent for service of process. Finally, the principal underwriter for the company must be a corporation organized under the laws of one of the states of the United States (or a person that is resident in and a citizen of the United States) with its principal place of business in, the United States, any accountant to the company must be qualified to act as an "independent public accountant" to the company within the meaning of the Securities Act and must have a permanent place of business in the United States and the company must maintain at least a copy of its books and records in the United States.

295 The SEC staff indicated that, as of March 19, 1999, only one Canadian fund was registered with the SEC. SEC Release No. IC-23745 (Mar. 19, 1999), 64 Fed. Reg. 14,648, 14,649 n.10 (Mar. 26, 1999).

296 SEC Release No. IC-8596 (Dec. 2, 1974).

297 Commenters representing foreign interests objected to a range of SEC regulation, including the *per se* rules prohibiting transactions with affiliates or interested persons, Letter from Crystal & Driscoll, P.C. (Jan. 30, 1975) ("Clearly, no other country has such stiff rules."); *see also* Letter from The Investment Trusts Association (Japan) (Mar. 11, 1975), structural differences between U.S. and foreign funds, Letter from Save & Prosper Group Ltd. (Jan. 27, 1975) ("[T]he majority of European funds are of a contractual, rather than corporate structure."), voting requirements, Letter from Leva, Hawes, Symington, Martin & Oppenheimer (Aug. 8, 1974) ("The German Investment Company Act does not permit, and most certainly does not contemplate, giving voting rights to investors…."), and corporate governance matters, Letter from the Ministry of Finance of Japan (Mar. 1, 1975) (the requirement for a majority of independent members of a fund's Board of Directors is inconsistent with the Japanese-approved contractual form of investment trust).

298 SEC Release No. IC-8959 (Sept. 26, 1975).

299 SEC Release No. IC-8959 (Sept. 26, 1975). Under the SEC's guidelines, an applicant would also have to provide certain information, such as a comparison of applicable foreign law and a section-by-section description of each provision of the Investment Company Act with which the applicant was unable or unwilling to comply, together with an explanation for the proposed noncompliance.

300 SEC Release No. IC-13691 (Dec. 23, 1983). Legislative attempts to relax the standard imposed by § 7(d) have also been unsuccessful. *See, e.g.*, H.R. 8256, 93d Cong., 1st Sess. (1973) (bill to amend § 7(d) to permit the SEC, in considering applications under § 7(d), to "take into account the differing laws, regulations, customs, and business conditions of particular countries in which such companies are organized and the adequacy of existing regulation in such countries"). In 1984, the SEC again attempted to encourage Congress to increase the SEC's flexibility in granting orders under § 7(d) by proposing amendments to the statutory standard. In particular, the amendments would have permitted the SEC, under its rulemaking and exemptive authority, to grant exemption from any provision of the Investment Company Act to a foreign operating investment company upon findings that:

> (1) compliance with such provision would be unduly burdensome because the company is organized or otherwise created under foreign law and invests primarily in foreign securities, (2) the laws under which such company operates provide protections for investors which serve the same purposes as the protections provided by the provisions of [the Investment Company Act] from which exemption is requested or that specific conditions agreed to by the company provide such investor protections, (3) the exemption is consistent with the protection of investors and the purposes fairly intended by the policy of [the Investment Company Act], and (4) such company is not operated for the purpose of evading the provisions [of the Investment Company Act]….

See Letter from John S.R. Shad, Chairman, SEC, to Thomas P. O'Neill, Jr., Speaker of the U.S. House of Representatives (Jan. 31, 1984), introduced for consideration by the House.

301 *Banque Indosuez Luxembourg* (avail. Dec. 10, 1996).

302 The staff's proposal defined an "operating foreign investment company" as a company that is not organized or otherwise created under the laws of the United States or of a State, is primarily engaged in investing in securities of non-United States issuers, and at all times during the three-year period immediately preceding the filing of an application for registration under this title has met criteria prescribed by [SEC] rule or order to demonstrate that it is a *bona fide* operating foreign investment company. 1992 Report at 102.

303 1992 Report at 102.

304 *See* § 15.05[7].

305 1992 Report at 206.

306 1992 Report at 206.

307 Letter from John S.R. Shad, Chairman, SEC, to Thomas P. O'Neill, Jr., Speaker of the U.S. House of Representatives (Jan. 31, 1984). The SEC's proposed legislation was never introduced in Congress. 1992 Report at 199.

308 1992 Report at 199.

309 1992 Report at 206.

310 Paul F. Roye, Director, SEC Division of Investment Management, Remarks before the *Fédération Européene des Fonds et Sociétés d'Investissement, Regulation of Mutual Funds in the United States—A Successful Regulatory Regime* (Sept. 22, 2000). Roye stated that approximately 13% of the U.S.-registered open-end funds are managed by non-U.S. advisers, as are 12% of closed-end funds.

311 *See ASA Ltd.*, SEC Release Nos. IC-26582 (Aug. 27, 2004) (notice of application) and IC-26602 (Sept. 20, 2004) (Order); *cf. Man-Glenwood Lexington TEI, LLC* (avail. Apr. 30, 2004) ("The [SEC] has required non-Canadian, non-U.S. investment companies seeking registration orders under section 7(d) of the [Investment Company] Act to comply with the conditions of rule 7d-1."); *see also Alternative Investment Partners Absolute Return Fund STS* (avail. July 10, 2006).

U.S. Regulation of the International Securities and Derivatives Markets, § 15.09, SPECIAL ISSUES FOR U.S. FUNDS HOLDING FOREIGN SECURITIES

U.S. Regulation of the International Securities and Derivatives Markets
1 Edward F. Greene, Alan L. Beller, Edward J. Rosen, Leslie N. Silverman, Daniel A. Braverman, Sebastian R. Sperber, Nicolas Grabar & Adam E. Fleisher, U.S. Regulation of the International Securities and Derivatives Markets § 15.09 (11th and 12th Editions 2014-2017)
11th and 12th Editions

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As a natural consequence of the SEC's "mirror fund" approach to enabling foreign portfolio investment by U.S. investors and the desire of many U.S. investors to have increased investments in non-U.S. securities, many fund sponsors have established U.S.-domiciled investment companies that invest in part or primarily in foreign securities. [312] These funds are generally closed-end management investment companies (though some are open-end) established in the United States and registered under the Investment Company Act. Investment objectives have included investing principally in the securities of a number of countries other than the United States (so-called "international funds"), in the securities of a number of countries including the United States (so-called "global funds") or in the securities of a single country (so-called "country funds"). [313]

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In addition to local law requirements and the requirements of the Investment Company Act, a fund designed to invest in foreign securities can raise issues beyond those faced by investment companies generally, certain of which are summarized below.

[1] Fund Structure and Investments

A fund investing in foreign securities must of course comply with the laws of the foreign country or countries in which it invests, and an early examination of applicable foreign investment, exchange control, securities and tax laws must therefore be made to ensure that the fund's investment objectives can be accomplished. Particular attention should be directed to restrictions on investments in specific sectors or industries, exchange controls that could affect conversion of local currency into dollars, the availability of repatriation guarantees and related governmental approvals and taxation (including applicability of withholding taxes) of payments to nonresidents, such as the fund, of dividend and interest income and of capital gains. Where a local investment vehicle is used to avoid some of these issues, the vehicle must be structured so that it is not a separate investment company subject to the Investment Company Act. Section 12(d) of the Investment Company Act imposes strict limitations on the ability of a registered investment company to invest in securities of other investment companies. [314]

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Where the local vehicle may have too much substance to be disregarded as a separate entity, the fund may attempt to take advantage of § 12(d)(1)(E) of the Investment Company Act, which provides an exemption from the limitation on holdings of another fund imposed by § 12(d) where the U.S.-registered fund holds only securities of the second-tier fund and U.S. government securities and meets certain other requirements. [315] Recent amendments to § 12(d)(1) by the NSMIA have made these issues easier to address in certain circumstances. [316]

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Management investment companies must be classified under the Investment Company Act as either "diversified" or "nondiversified." To be classified as "diversified," at least 75% of the value of the fund's total assets must be represented by cash, U.S. government securities and other securities limited in respect of any one issuer to an amount not greater in value than 5% of the total assets of the fund and not more than 10% of the outstanding voting securities of such issuer. [317] A fund that elects to be classified as "nondiversified" is not required to meet these tests, but will still be subject to the diversification requirements of U.S. federal tax laws described below.

For purposes of both the Investment Company Act and U.S. tax laws, securities issued by foreign governments are treated in the same manner as securities issued by private companies; they do not benefit from the same treatment accorded to U.S. government securities. To date, neither the SEC nor the IRS has taken formal action permitting a country fund to substitute securities of its "host" government for those of the United States in satisfying the diversification tests. This may affect the short-term management of a country fund during the initial start-up period and during any period in which the portfolio manager believes a defensive posture is appropriate. Difficulties can be particularly acute where local exchange control rules restrict or prohibit free exchange from local currency into U.S. dollars or transfer of currency out of the local jurisdiction after liquidation of local investments, since in such cases the ability to invest in U.S. government securities for defensive or cash management purposes may be limited.

[2] Custody

Use of foreign custodians for foreign portfolio securities must comply with applicable SEC rules. Under a previous version of Rule 17f-5 under the Investment Company Act, the principal alternatives were:

- a local branch or office (where one exists) of a U.S. bank that qualifies as a custodian under the Investment Company Act, in which case no specific additional rules must be complied with;
- a banking institution organized under the laws of a foreign country, in which case the foreign institution must meet certain requirements under Rule 17f-5 under the Investment Company Act;
- a non-U.S. securities depositary or clearing agency that operates "the system for the central handling of securities or equivalent book-entries" in the

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  foreign country of its organization and that is regulated by a "foreign financial regulatory authority"; or
- a non-U.S. securities depositary or clearing agency that operates a "transnational system for the central handling of securities or equivalent book-entries." [318]

This issue was a significant problem for registered investment companies seeking to invest in a jurisdiction where securities can only be held through a depositary in book-entry form and where there is not clearly a single depositary that is "the central system" in the jurisdiction. [319] In certain cases, the SEC staff has granted no-action relief, although the bases for relief have varied substantially as a result of the differences in the practices among the countries in question. [320]

Recognizing the substantial difficulties associated with foreign custody issues, the SEC amended Rule 17f-5 under the Investment Company Act in 1997 to expand the types of institutions that may serve as custodians. [321] The SEC delayed implementation of the new amendments twice, [322] in response to industry concerns and finally implemented the changes in 2000. [323] Revised Rule 17f-5 applies only to funds maintaining assets with a foreign bank custodian and not to

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custody arrangements with foreign securities depositaries. [324] The revised rule permits a fund to utilize "eligible foreign custodians," which are regulated non-U.S. banks or majority-owned direct or indirect subsidiaries of U.S. banks or bank holding companies. [325] In selecting such a foreign custodian, a fund's board must ensure that certain standards are observed in (i) selecting the custodian, (ii) establishing contractual relations with the custodian and (iii) monitoring the appropriateness of maintaining the arrangement. [326]

Partly in response to the industry's concerns regarding Rule 17f-5, the SEC adopted Rule 17f-7 under the Investment Company Act to govern custody arrangements with foreign securities depositaries. [327] Under Rule

17f-7, funds may maintain their foreign assets only with an "eligible securities depositary," which must: (i) operate a central system for handling securities and be regulated by a foreign financial regulatory authority, (ii) hold the fund's assets under conditions no less favorable than those that apply to other participants, (iii) maintain records identifying the assets of each participant and keep the depositary's own assets separate, (iv) provide periodic reports to participants, and (v) be subject to periodic review by regulatory authorities or independent accountants. [328] To comply with Rule 17f-7, the fund or its adviser must receive from its primary custodian (or its agent) an initial risk analysis of the depository arrangements with the depository, and the fund's contract with its primary custodian must state that the custodian will monitor risks and promptly notify the fund or its adviser of

material changes in risks. The primary custodian and other custodians also must agree to exercise reasonable care in this regard. [329]

[3] Investment Advisers

A fund may be set up to have a single investment adviser or a number of investment advisers, each with responsibility for a different portion of the fund's portfolio or with one or more sub-advisers. Any investment adviser to a registered investment company, including a foreign adviser or sub-adviser, is required to register under the Advisers Act. The SEC staff has taken the position that the recordkeeping and reporting requirements and certain other rules of the Advisers Act apply to a registered investment adviser in respect of both U.S. and foreign customers, and that the Advisers Act in certain circumstances can apply to or result in the imposition of requirements on affiliates of registered advisers. [330]

[4] Disclosure

In addition to registering under the Investment Company Act, funds making public offerings in the United States must register the offerings under the Securities Act. Special disclosure forms have been designated by the SEC for the Securities Act registration of investment companies. These forms include disclosure requirements particular to investment companies, including regarding investment objectives, trading policies, advisory arrangements, fund expenses, accounting policies for derivatives [331] and many others. Prospectuses of funds investing in foreign securities generally contain disclosure relating to the securities markets and economic and political background of the countries in which they plan to invest, as well as the effect of local laws on the ability of the fund to invest, reinvest and hold securities and to comply with U.S. requirements. The level of disclosure depends on a number of factors, including the percentage of

the fund's assets expected to be invested in a particular country. The disclosure can also be expected to depend on the degree to which the country's economy, political system and securities markets present special risks.

[5] U.S. Taxation

Like other U.S.-registered investment companies, a fund investing in foreign securities can effectively avoid most U.S. federal income tax at the corporate level if it meets certain requirements. [332] While a complete discussion of tax issues for registered investment companies is beyond the scope of this book, the following summarizes the principal requirements for the operation of such a company to effectively avoid taxation at the corporate level.

First, the fund must be registered under the Investment Company Act. [333] Second, the fund must meet certain diversification requirements. It generally may not invest more than 25% of its assets in the securities of any one issuer, including any foreign government. [334] At least 50% of its assets must be invested in cash, U.S. government securities and securities of issuers each of which does not represent more than 5% of the fund's assets. [335] Third, at least 90% of the fund's gross income must derive from interest, dividends, gains from the sale or other disposition of securities or foreign currency and certain other categories of income related to securities investment. [336] Fourth, the fund must distribute to shareholders at least 90% of its net investment income from interest, dividends, options and the like and short-term capital gains (net of long-term capital losses). [337] Income subject to the distribution requirements includes realized gains attributable to currency fluctuations. It is therefore important that local exchange control regulations be flexible enough to permit the fund to repatriate a sufficient portion of its earnings to cover required distributions.

Under current law, the fund will be subject to U.S. federal income tax on net long-term capital gains (reduced by any net short-term capital losses) and other investment income not distributed to shareholders and a 4% excise tax to the extent the fund does not distribute 98.2% of its capital gains and 98% of its other net income. [338] Income tax paid by the fund on undistributed long-term capital gains (but not the excise tax) may be claimed as a credit by shareholders. [339]

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These distribution requirements make accumulation of realized gains by U.S.-registered investment companies burdensome and potentially costly. As a result, many U.S. funds have dividend reinvestment plans. Reinvested dividends generally are treated as distributed dividend income for U.S. tax purposes. [340]

Payments on foreign securities held by a U.S. investment company may be subject to withholding taxes imposed by the country from which the payments are sourced. If more than 50% of the total value of the fund's assets is invested in stocks or securities of foreign corporations as of the end of the taxable year, the fund may elect to pass-through the foreign tax credit to its shareholders who, if they are U.S. taxpayers, can thus obtain the benefit of the credit. [341] As a consequence of the election, the shareholders (including shareholders that are not U.S. taxpayers) are treated as receiving, and the fund is treated as distributing, a dividend equal to the amount of foreign taxes paid and each shareholder that is a U.S. taxpayer is entitled to a foreign tax credit or deduction for his or her proportionate share of such amount. [342]

Non-U.S. shareholders generally will be subject to withholding tax at a rate of 30% in respect of dividends paid by a U.S. investment company, subject to reduction by an applicable tax treaty. [343] It therefore may not be tax-efficient for non-U.S. persons to invest in foreign securities through U.S. investment companies.

Footnotes

312 For a description of certain issues that can arise when non-U.S. investment companies seek to invest in U.S. securities, *see* § 3.05[1], Note 521 (discussing certain restrictions applicable to participation in U.S. initial public offerings).

313 The SEC staff has provided guidance as to when a registrant may use the terms "international" and "global" in the name of a fund and requires that the name of a particular region or country be used where the fund will have a concentration of investments in that region or country. *See, e.g.*, Letter from SEC, Division of Investment Management, to Registrants (Feb. 22, 1993) (citing Letter from SEC, Division of Investment Management, to Registrants (Jan. 3, 1991)). For these purposes, a fund may count securities of issuers (i) that are organized under the laws of the particular country, (ii) for which the principal securities trading market is in that country or (iii) that derive a significant proportion (at least 50%) of their revenues or profits from goods produced or sold, investments made or services performed in the country or that have at least 50% of their assets situated in that country. Letter from Registrants, SEC, Division of Investment Management, to Registrants (Feb. 22, 1993) (citing Letter from SEC, Division of Investment Management, to Registrants (Jan. 3, 1991)). Note, however, that under Rule 35d-1 under the Investment Company Act adopted January 17, 2001, in order for a registered investment company to have a name suggesting that it focuses on a particular type of investment, the company must invest at least 80% of its assets in the type of investment suggested by its name. Rule 35d-1 under the Investment Company Act; *see also* SEC, Division of Investment Management, Frequently Asked Questions about Rule 35d-1 (Investment Company Names) (Dec. 4, 2001).

314 The limitations on a so-called "fund of funds" prohibits, subject to certain exceptions, a registered investment company (and companies under its control) from investing in the securities of another investment company if, after the acquisition, the acquiring group of companies owns in the aggregate: (i) more than 3% of the voting stock of the acquired company, (ii) securities of the acquired company representing more than 5% of the value of the total assets of the acquiring group of companies or (iii) securities of the acquired company and all other investment companies representing more than 10% of the value of the total assets of the acquiring group of companies. § 12(d)(1)(A) of the Investment Company Act. The restriction on purchasing more than 3% of the voting stock of another investment company applies in the case of investments made by a registered investment company in a fund relying on § 3(c)(1) or § 3(c)(7) of the Investment Company Act and investments by such a fund in securities of any registered investment company. Sales by a registered open-end investment company of its securities to any other investment company are similarly constrained. §§ 12(d)(1)(A) and 12(d)(1)(B) of the Investment Company Act. The SEC has adopted rules that to a certain extent expand the circumstances in which an investment company may invest in shares of another investment company. SEC Release No. IC-27399 (June 20, 2006).

The SEC staff has under certain circumstances taken the position that § 12(d) will not apply to a fund's investment through the vehicle of another fund where the fund is U.S. domiciled and is the sole owner, and will control the management and investment policies, of the vehicle and the arrangement will not result in any additional sales load to the fund or significant duplicative custodian fees or other costs to fund shareholders. *See, e.g.*, *The Spain Fund, Inc.* (avail. Mar. 28, 1988). The SEC staff has also taken the position in such cases that the offering is not an indirect offering of a foreign investment company in violation of § 7(d) of the Investment Company Act. The SEC staff has extended this reasoning to a three-tier fund structure where a registered closed-end investment company invested only in the securities of an offshore fund that, in turn, invested only in the securities of another registered closed-end fund. *Man-Glenwood Lexington TEI, LLC* (avail. Apr. 30, 2004).

The SEC staff has permitted a registered closed-end investment company to acquire securities of foreign investment companies in excess of the limitations on such ownership imposed by § 12(d)(1)(A) of the Investment Company Act. *The France Growth Fund, Inc.* (avail. July 15, 2003). In granting the requested no-action relief, the SEC staff relied, among other things, on the fact that the relevant foreign investment companies would not acquire securities of other investment companies. However, in the context of a fund of funds arrangement previously permitted under an exemptive order, the staff recently permitted the acquired companies in the fund of funds structure to acquire the securities of unaffiliated investment companies for short-term cash management purposes, even in excess of § 12(d)(1)(A) limits. *John Hancock Trust, et al.* (avail. Apr. 12, 2012).

The SEC staff also stated that it would not recommend enforcement action under § 7(d) of the Investment Company Act because the registered investment company would only acquire securities issued by foreign investment companies that conducted offerings of their securities in the United States or to U.S. persons in accordance with § 3(c)(7) of the Investment Company Act and would comply with the diversification requirements of § 5(b)(1) of the Investment Company Act. *See* text accompanying *infra* Note 317. Because the registered investment company was not currently engaged in a public offering of its shares, the SEC staff expressly did not consider whether the registered investment company's proposed actions would constitute an indirect public offering or sale of the foreign investment company's securities in the United States.

315 *See The Thai Fund, Inc.* (avail. Nov. 30, 1987) (confirming the availability of the exception provided by § 12(d)(1)(E) of the Investment Company Act and also granting no-action relief with respect to § 7(d)); *see also The Thai Fund*, SEC Release Nos. IC-16066 (Oct. 21, 1987) (notice of application) and IC-16130 (Nov. 17, 1987) (Order) (providing an exemption with respect to the requirement of § 12(d)(1)(E) of the Investment Company Act that all principal underwriters of the fund be U.S.-registered broker-dealers).

316 Such amendments added a new § 12(d)(1)(G) to the Investment Company Act that provides an additional exemption for investments by registered open-end investment companies in securities of other open-end

investment companies or unit investment trusts if (i) they are both part of the same group of investment companies (defined as two or more registered investment companies that hold themselves out to investors as related companies for purposes of investment and investor services) and (ii) securities of the acquired company, securities of other registered open-end investment companies and unit investment trusts that are part of the same group of investment companies, government securities and short-term paper are the only investments held by the acquiring company.

317 § 5(b)(1) of the Investment Company Act.

318 17 C.F.R. § 270.17f-5 (1997).

319 If a jurisdiction has no system that may qualify under Rule 17f-5 and applicable law prohibits the holding of local securities outside that jurisdiction or there is no practical alternative manner of satisfying the requirements of § 17(f), it appears that some investment companies have used derivatives to achieve synthetic positions in the local securities. Some have also argued that where equity securities are represented by American deposit receipts ("ADRs"), there is no need for a Rule 17f-5 custodian other than with respect to the ADRs. This argument assumes that the depositary for the shares bears the custodial risk with respect to the underlying equity securities.

320 *See, e.g.*, *ING Bank N.V.* (avail. May 24, 1999); *Templeton Russia Fund Inc.* (avail. Apr. 18, 1995); *Jardine Fleming China Region Fund, Inc.* (avail. Apr. 26, 1993); *Custody of B Shares Trading on the Shenzhen and Shanghai Securities Exchanges* (avail. Apr. 26, 1993).

In the case of China, the SEC concluded in *Custody of B Shares* that each of several nonoverlapping depositaries operating book-entry systems in a single jurisdiction with respect to the same class of shares could act as custodian for a registered investment company, based in part on the fact that each of the depositaries for shares trading on the Shenzhen Securities Exchange was (i) either a foreign branch of a U.S. bank having capital, surplus and undivided profits at least equal to $500,000 or a foreign branch of a foreign bank having shareholders' equity of at least $200 million and (ii) the sole depositary for a particular issue of a class of shares. In the case of shares traded on the Shanghai Securities Exchange, the SEC granted no-action relief, subject to satisfaction of certain conditions, based on the fact that the depositary in question was the "central" book-entry depositary and sole clearing agent, transfer agent and registrar of all shares of the class traded on that Exchange.

321 SEC Release No. IC-22658 (May 12, 1997).

322 SEC Release No. IC-23201 (May 21, 1998); SEC Release No. IC-23815 (Apr. 29, 1999).

323 SEC Release No. IC-24424 (Apr. 27, 2000); *see also* SEC Release No. IC-23815 (Apr. 29, 1999).

324 Rule 17f-5 under the Investment Company Act. Arrangements with foreign depositaries are addressed by Rule 17f-7 under the Investment Company Act, discussed below.

325 Rule 17f-5 under the Investment Company Act. *See also The Brink's Company* (avail. Feb. 11, 2014) (granting relief from the requirements of § 17(f)(1) of the Investment Company Act to registered investment companies that place their gold bullion and other precious metals in the custody of a vault services company in the United Kingdom, where such company was not an entity permitted to serve as a custodian to a registered investment company pursuant to the rules and regulations adopted under § 17(f)).

326 SEC Release No. IC-24424 (Apr. 27, 2000).

327 SEC Release No. IC-24424 (Apr. 27, 2000). The SEC has declined to apply the requirements of Rules 17f-5 and 17f-7 under the Investment Company Act to funds that hold securities with a U.S. depositary that are ultimately custodied with a foreign custodian or depositary. SEC Release No. IC-25934 (Feb. 13, 2003), 68 Fed. Reg. 8438, 8441 (Feb. 20, 2003).

328 Rule 17f-7 under the Investment Company Act. Rule 17f-7 states that "a system for the central handling of securities" has the meaning set forth in Rule 17f-4 under the Investment Company Act. This definition was removed from Rule 17f-4, however, after recent changes to that provision. The SEC staff has stated that until it corrects this discrepancy, it would interpret "a system for central handling of securities" consistently with the definition previously included in Rule 17f-4, as "a system where all securities of any particular class

or series of any issuer deposited within the system are treated as fungible and may be transferred or pledged by bookkeeping entry without physical delivery of the securities." *Austraclear Ltd.* (avail. Apr. 28, 2004).

329 Rule 17f-7(a)(1) under the Investment Company Act; SEC Release No. IC-24424 (Apr. 27, 2000).

330 *See* § 16.02.

331 *See also* Memorandum from SEC, Division of Investment Management, Regarding Mutual Funds and Derivative Instruments 11 (Sept. 26, 1994); Letter to the Investment Company Institute Regarding Derivative-Related Disclosures by Investment Companies (July 30, 2010). The SEC's Division of Investment Management has indicated that if more than 5% of a fund's net assets are at risk from its involvement in derivative instruments and transactions, its prospectus should: (i) identify the types of derivative transactions in which it will engage, (ii) briefly describe the characteristics of such transactions or instruments, (iii) state the purpose for which the fund will use derivatives, and (iv) identify the risks of derivative instruments and transactions. Letter from SEC, Division of Investment Management, to Registrants (Feb. 25, 1994). Certain uses of exchange-traded futures contracts and options on futures by registered investment companies can implicate the provisions of the CEA applicable to commodity pool operators.

332 I.R.C. Chapter 1, Subchapter M (§§ 851-860G) provides for the U.S. federal income taxation of regulated investment companies.

333 I.R.C. § 851(a)(1).

334 I.R.C. § 851(b)(3)(B).

335 I.R.C. § 851(b)(3)(A).

336 I.R.C. § 851(b)(2).

337 I.R.C. § 852(a)(1).

338 I.R.C. § 4982.

339 I.R.C. § 852(b)(3)(D)(ii).

340 *See* I.R.C. § 305(b)(1); Rev. Rul. 79-42, 1979-1 C.B. 130.

341 I.R.C. § 853.

342 I.R.C. § 853. Non-U.S. shareholders of a U.S. investment company that are not U.S. taxpayers generally would not benefit for tax purposes in their local jurisdiction from this special U.S. regime for tax credits.

343 I.R.C. §§ 871(a)(1)(A) and 881(a)(1); *see also* Treas. Reg. § 1.1441-6. However, certain capital gains dividends are not subject to U.S. withholding tax. I.R.C. § 852(b)(3)(B); Treas. Reg. § 1.1441-3(c)(2)(i)(D).

U.S. Regulation of the International Securities and Derivatives Markets, § 15.10, ENFORCEMENT

U.S. Regulation of the International Securities and Derivatives Markets
1 Edward F. Greene, Alan L. Beller, Edward J. Rosen, Leslie N. Silverman, Daniel A. Braverman, Sebastian R. Sperber, Nicolas Grabar & Adam E. Fleisher, U.S. Regulation of the International Securities and Derivatives Markets § 15.10 (11th and 12th Editions 2014-2017)
11th and 12th Editions

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The SEC possesses broad powers of enforcement under the Investment Company Act that extend not only to registered investment companies but also to other persons, including funds that are exempt from the Act's registration and reporting requirements. For instance, §§ 42(a) and 42(b) empower the SEC to conduct investigations to determine whether any violation of the Investment Company Act has occurred. In addition, the Securities Enforcement Remedies and Penny Stock Reform Act of 1990 ("SERPSA") [344] significantly expanded the ability of the SEC to seek civil penalties. Pursuant to SERPSA, the SEC may seek up to $150,000 against a natural person and up to $725,000 against an entity

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for violations of the Investment Company Act. [345] Further, SERPSA enables the SEC to order respondents to "cease and desist" from any act or practice that violates the Investment Company Act and to "take steps to effect compliance" with the Act. [346] Although notice and opportunity for hearing are generally required in connection with SEC hearings, in certain emergency situations, the SEC may issue temporary orders to persons that are subject to regulation, such as brokers, dealers, investment advisers, investment companies, etc., without a hearing. [347]

The SEC is also able to seek temporary and permanent injunctions in court to curtail any violations of the Investment Company Act and to enforce compliance with the Act. [348] Any evidence of violations may also be referred by the SEC to the Department of Justice for the institution, at the Department of Justice's discretion, of criminal proceedings.

In addition, under § 47 of the Investment Company Act, any contract that violates the Investment Company Act is void and unenforceable and, to the extent such a contract has been performed, may be rescinded, unless in either case a court finds that enforcement of the contract would produce a more equitable result. [349]

One court has held that an implied private right of action exists under § 7(d) of the Investment Company Act for claims brought against non-U.S. investment companies for publicly offering their securities through U.S. jurisdictional means without registering with the SEC. [350] These nonregistration claims are subject to a one-year limitation period. [351] Subsequent cases, however, have adopted more restrictive approaches to finding implied rights of action under other provisions of the Investment Company Act, calling into question whether other courts would find an implied private right of action under § 7(d). [352]

Footnotes

344 Securities Enforcement Remedies and Penny Stock Reform Act of 1990, Pub. L. No. 101-429, 104 Stat. 931 (1990); *see* § 14.11[2][b] for a discussion of the relevant SERPSA provisions in the Exchange Act.

345 § 42(e) of the Investment Company Act; 17 C.F.R. § 201.1004, Table IV to Subpart E of Part 201.

346 § 9(f)(1) of the Investment Company Act.

347 § 9(f)(3) of the Investment Company Act.

348 § 42(d) of the Investment Company Act.

349 The SEC possesses additional enforcement powers under the Investment Company Act that are applicable only to registered investment companies, including the authority to inspect accounts, books and other

records of a registered investment company pursuant to § 31(b) of the Investment Company Act and the power to bring court actions in situations involving a breach of fiduciary duty pursuant to § 36 of the Investment Company Act.

350 *Blatt v. Merrill Lynch, Pierce, Fenner & Smith Inc.*, 916 F. Supp. 1343, 1350–52 (D.N.J. 1996) (implying a one-year limitation period for nonregistration claims under § 7(d) of the Investment Company Act by analogy to the express limitations period provided for nonregistration claims under § 12(a)(1) of the Securities Act).

351 *Blatt v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 916 F. Supp. 1343, 1352 (D.N.J. 1996).

352 *See Olmsted v. Pruco Life Insurance Co.*, 283 F.2d 429, 434, 436 (2d Cir. 2002) (declining to find a private right of action for violations of §§ 26(f) and 27(i) of the Investment Company Act and noting that, although "an overwhelming majority of courts interpreting the [Investment Company Act] have recognized implied private rights of action to enforce many of its sections," many of those cases were decided when "courts had more latitude to weigh statutory policy and other considerations than they do now"); *see also In re Merrill Lynch & Co., Inc. Research Reports Securities Litigation*, 272 F. Supp. 2d 243, 258 (S.D.N.Y. 2003) ("Notably, since the Second Circuit's decision in *Olmsted*, there appear to have been no decisions in which a court has found an implied private right of action under any section of the [Investment Company Act]."); *meVC Draper Fisher Jurvetson Fund I, Inc. v. Millennium Partners, L.P.*, 260 F. Supp. 2d 616, 621–25 (S.D.N.Y. 2003).

U.S. Regulation of the International Securities and Derivatives Markets, § 15.11, APPLICATION OF STATE SECURITIES LAWS

U.S. Regulation of the International Securities and Derivatives Markets
1 Edward F. Greene, Alan L. Beller, Edward J. Rosen, Leslie N. Silverman, Daniel A. Braverman, Sebastian R. Sperber, Nicolas Grabar & Adam E. Fleisher, U.S. Regulation of the International Securities and Derivatives Markets § 15.11 (11th and 12th Editions 2014-2017)
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In light of the effective prohibition of § 7(d) of the Investment Company Act on public offerings in the United States by foreign-domiciled investment companies, most such companies may only offer their securities in the United States on a private placement basis in order to be exempt from registration under both the Investment Company Act and the Securities Act. Exemptions from state securities law registration requirements are also generally available for such offerings since they are typically marketed to U.S. institutional investors (as distinguished from the general or "retail" public). In 1996, the NSMIA amended § 18 of the Securities Act to provide for federal preemption of any state laws and regulations requiring registration of securities or securities transactions that apply to a "covered security." Among other categories of "covered securities"described in the NSMIA that might apply to private offerings of foreign-domiciled investment companies as described above, securities that are offered or sold to "qualified purchasers," as such term is to be defined by the SEC by rule, are preempted. This development should facilitate marketing such offerings in all 50 states in a uniform manner. [353] Currently, however, although state laws provide exemptions for sales of securities to specified types of institutions, including banks, broker-dealers and insurance companies, the types of institutions to which exempt sales may be made can vary from state to state, as can other state securities law requirements incidental to the availability of an exemption thereunder. [354] The NSMIA provides for preemption of state securities registration and filing requirements with respect to "covered securities" in certain transactions that are exempt from federal registration requirements pursuant to regulations promulgated by the SEC under § 4(a)(2) of the Securities Act. Such offerings would include those exempted by Rule 506 of Regulation D under the Securities Act; however, technically, securities offered pursuant to § 4(a)(2) itself

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would not be considered "covered securities," as they are not exempt "pursuant to … regulations issued under" § 4(a)(2) of the Securities Act.

Where, on the other hand, a sponsor elects to follow the SEC's "mirror fund" approach and establish a U.S. registered investment company to invest in foreign securities for purposes of conducting a U.S. offering and market the fund's shares to the general public, the offering typically will also be subject to the registration requirements of state securities laws. In the past, registration under these statutes could lead to a significant additional administrative burden and expense. However, pursuant to the preemptive provisions of the NSMIA, one of the categories of preempted "covered securities" consists of any security issued by an investment company registered under the Investment Company Act or that has filed a registration statement thereunder. Accordingly, issuers of these types of securities will now register exclusively with the SEC and will no longer be required to register under states' laws. The NSMIA permits the states to take action, however, to require the filing with the relevant state securities regulator of (i) any document filed with the SEC, together with periodic reports of the value of securities sold to persons in the state solely for notice purposes, and (ii) a consent to service of process in the state. In addition, the states may require the payment of fees in connection with such filings. Without taking any further action, the states may continue to collect fees payable in connection with such offerings as required under state law in effect on October 10, 1996. Significantly, investment companies no longer need to receive approval from a state with respect to its filing prior to commencement of the offering. As soon as the state notice filing and fee payment requirements are met, the investment company's securities may be offered and sold in the state.

Footnotes

353 In the "covered security" context, the SEC is likely to define the term "qualified purchaser" differently than it is defined for purposes of § 3(c)(7) of the Investment Company Act. In its recent proposal to revise Regulation D, the SEC has included a request for comment on whether to define the proposed term "large accredited investor" as a "qualified purchaser" for purposes of § 18 of the Securities Act. The release also notes that the SEC's prior proposal to equate that term with the definition of the term "accredited investor" in Regulation D is no longer under consideration by the SEC.

354 *See* § 7.09 for a discussion of the application of state securities laws in the context of private placement transactions.