MEMORANDUM

January 16, 1963

To: The Commission

From: Division of Corporate Regulation

Re: Exchange or Swap Funds - Investment Company Act of 1940

I. Background

In its minute dated December 1, 1961, in the case of Empire Fund, Inc. (File Nos. 2-1839 and 811-1014) the Commission stated that:

> "its determinations related only to the pending Empire Fund registration statement and did not relate to the broader questions of policy with respect to exchange funds discussed in the memorandum of the Division of Corporate Regulation dated November 24, 1961. It was understood that the staff would again review the general problems relating to exchange funds and prepare a further memorandum on the subject for the Commission's consideration."

The problems thus reserved are of immediate significance in that contemporaneously with this memorandum the Division of Corporation Finance and the Division of Corporate Regulation are submitting to the Commission a memorandum of recommendations on filings made by Stratton Fund (File 2-19985) proposing another exchange fund offering. Problems peculiar to that Fund are discussed in that memorandum and will not be repeated here.

Answers reached will also be significant in other cases. When Congress Street Fund offered its securities the persons depositing their securities for the exchange were considered to be "promoters" and an order under Section 17(b) was issued (Investment Company Act Release No. 3329, October 24, 1960).[1] We are required to issue further orders or take a no action position now when redemption in kind is required by a stockholder in Congress Street Fund. Other persons are also proposing types of exchange funds which raise similar or related problems. [Consultants Mutual Investments, Inc. (File 2-20962) and Penn Center Investment Co. (File 132-3).]

The purpose of this memorandum is to make overall recommendations to the Commission with respect to the general problems in exchange fund offerings which remain

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1 A similar order, under similar circumstances, had previously been issued in the matter of Centennial Fund Inc. (Investment Company Act Release No. 2946, December 15, 1959).

unresolved. For a summary of some of the history of exchange funds before the Commission, see Appendix A annexed.

II. The Problems Presented

Problems general to all exchange funds may be stated as follows:

(a) whether future sales for cash of shares of an exchange fund should be permitted and whether the persons originally depositing their securities for the purpose of effecting the exchange are promoters;

(b) questions of liquidity required of a fund issuing redeemable securities and the impact thereon of restricted securities in the portfolio;

(c) the proper minimum purchase requirement on the initial exchange;

(d) whether the initial offering should be limited substantially to exchanges for securities.

III. Recommendations

(a) This Division continues to hold the view that, subsequent to the initial offering and the simultaneous exchange of fund shares of transferred securities, no further public offering of securities is to be made by an exchange fund (except that such a fund may issue additional shares to its shareholders upon the reinvestment of income dividends or capital gain distributions and may issue additional shares to its shareholders by stock dividends or recapitalizations) without the express consent of the Commission through a formal order entered upon application. This would protect the ordinary investor from having his investment diluted by the assumption of a substantial potential Federal capital gains tax liability arriving from another shareholder's transferred securities.

In the first two offerings by exchange funds (Centennial Fund and Congress Street Fund), upon this Division's recommendation, the Commission considered all depositors to be promoters and permitted the offerings to become effective only after the issuance of an order under Section 17(b) of the Investment Company Act. The purpose of these recommendations was to retain within the Commission some regulatory jurisdiction should the funds, after the initial exchange offering, propose a sale of the fund's shares for cash.

Thereafter, in connection with an application by a third fund, a question was raised at the Commission table as to whether investors in such cases should properly be deemed "promoters." Consideration was then given to achieving the same ends (prohibiting subsequent sales of fund's shares for cash) by means of Section 22(d) of the Act on the theory that each sale of fund shares was made at an individually negotiated price rather than a uniform public offering price, by reason of the shifting of the tax basis in each transaction.

This general problem was then considered by the Commission on February 13, 1961, in the matter of Westminster Fund Inc. It was there determined that no objection, whether under Section 17(a) or under Section 22(d), should be made because the fund had itself voluntarily undertaken to comply with the requirements the Division sought to achieve. No determination was made as to appropriate action if a subsequent fund should not "voluntarily" thus comply. A number of other exchange funds subsequently became effective on the same basis.[1]

In the Division's view it is imperative to retain a basis for limiting sales of exchange fund shares for cash. Whether or not all original depositors are deemed to be within the definition of "promoter" in Section 2(a)(29), all original depositors can, and in all known cases would, gain potential, if not actual, tax advantages from a future general offering of shares for cash at the expense of the incoming cash paying shareholders. It follows that we must retain regulatory jurisdiction to either prohibit or restrict future cash offerings of shares if a rational basis therefor can be found.

The Division recognizes the difficulties of the "promoter" concept where participation by affiliated persons of the investment adviser is absent and no longer urges this concept upon the Commission. The Division does urge the Commission to adopt the Section 22(d) approach, for we believe that it can be argued persuasively that each original depositor does not obtain fund shares at a uniform offering price because (1) of the shifting of the tax basis in each transaction, and (2) the individual negotiations involved in reaching a determination of the value of the particular stock he deposits. On this theory an exemption from Section 22(d) would be required, and the Commission can attach appropriate conditions to the granting of the exemption.

An advantage of the "promoter" approach was that the Commission could control the fairness of redemptions because a redemption, would constitute a transaction between affiliated persons requiring a Section 17(b) order. The Division believes this advantage can be retained either through appropriate conditions to an exemption under the Section 22(d) theory or by requiring the creation of fair redemption mechanics during the registration process.

(b) The presence of "control," "investment letter" or "restricted stock" in a portfolio obviously presents a problem of liquidity. In the Empire case the Commission determined that 10% of the assets could be so invested.[2] This Division is of the view that this limitation should not be increased. In suggesting this view the Division is aware that the 10% figure must be reached arbitrarily in the sense that a line must be drawn somewhere. We would be hard pressed to develop logical reasons why 10% is right and 15% is wrong.

As is pointed out in the Stratton Fund memorandum submitted herewith, the presence of restricted stock in the portfolio of a management company results, pro tanto, in a "management company" being restricted in respect of management investment determinations.

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[1] A fairly concise history of exchange funds is given in Appendix A.

[2] One Commissioner felt that none should be permitted (Commission Minute, November 30, 1961).

Of more significance, however, are the valuation problems raised by such stock. Either it will be valued on the basis of the market value for the same, unrestricted, stock which is traded on the market, or it will be valued by the board of directors. In either event, public investors cannot be sure that they are receiving fair treatment. While those who exchange the restricted stock for fund's shares may be presumed to be informed as to its value, other investors in the fund would not have the same knowledge, and the value accorded the restricted stock would have a con-commitant effect on the value of fund shares exchanged for unrestricted stock, both for purposes of the initial exchange and for redemption purposes. If the restricted stock should be valued at more than its real worth all other investors would be diluted. Limitation of exchange funds to no more than 10% of their assets being invested in restricted stock would hold this possible injury to other investors to a minimum.

(c) This Division is of the opinion that a minimum purchase of $10,000 per investor should be required in any public offering hereafter to be made by an exchange fund. The rationale of such a requirement is that investors in exchange funds are thereby more likely to possess a degree of financial knowledge ability and sophistication, and are more likely to consider carefully the advisability of investing therein, then may be predicted if there were to be no prescribed minimum. The Division is, of course, mindful that the ability to meet such a minimum requirement is not remotely conclusive as to the investors knowledge ability, but it appears a desirable condition in the forlorn hope that investors may more readily be able to comprehend the highly intricate taxation and other ramifications inherent in an exchange fund.

(d) It is the further view of this Division that an exchange fund should issue shares in its initial public offering only in exchange for securities which would be deposited by the holders thereof upon the basis of the fair market value of such deposited securities at the time of the exchange, and not for cash. This condition, however, should not preclude the initial $100,000 net worth required by Section 14(a) of the Investment Company Act from being supplied in cash prior to the commencement of a public offering, nor should it preclude an investor from supplying cash to round out fractional fund shares at the time of the exchange. This condition is grounded on the proposition that it is inherently unfair for an investor to purchase exchange fund shares for 100% cash, when other investors contributed assets may carry a potential tax liability of significant proportion and may thus operate to dilute the interest of the cash purchaser.