

INVESTMENT
COMPANY
INSTITUTE

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August 24, 1987

Kathryn B. McGrath, Director
Division of Investment Management
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, DC 20549

PUBLIC AVAILABILITY DATE: 10-30-87
ACT SECTION RULE
1940C 12(d)(3) ---

Re: Request For No-Action
Under Section 12(d)(3)
of the Investment
Company Act of 1940
and Rule 12d3-1
Thereunder

Dear Ms. McGrath:

Thank you for your letter of May 6, 1987 responding to the Institute's* submission dated April 29, 1987 requesting amendment to Rule 12d3-1 under the Investment Company Act to permit investment companies to purchase equity securities of foreign broker-dealers without first obtaining individual exemptive orders.

In your response, you state that you are unable to address by rulemaking action the problems we have identified until some future date since other more urgent regulatory matters take precedent. In view of the fact that it will be some time before a rulemaking proceeding can be instituted on this matter, the Institute respectfully requests a no-action response regarding purchases by investment companies of certain foreign equity securities that meet the rule's standards. Specifically, we request that the Division not recommend enforcement action to the Commission if investment companies acquire, without individual exemptive orders, the equity securities of foreign broker-dealers

* The Investment Company Institute is the national association of the American mutual fund industry. Its membership includes 2,143 open-end investment companies ("mutual funds"), their investment advisers and principal underwriters. Its mutual fund members have assets of about \$792 billion, accounting for approximately 90% of total industry assets, and have over 29 million shareholders. The Institute also represents the unit investment trust ("unit trust") industry. Its unit trust members sponsor trusts in which over \$110 billion have been deposited, accounting for over 90% of total industry deposits.

or other foreign issuers that derive more than 15 percent of their gross revenues from securities-related activities if such equity securities are either: (1) equity securities of one of the twelve major Japanese securities firms named below that have already been the subject of three exemptive orders; or (2) equity securities of an issuer listed on one of the world's twelve major stock exchanges named below. We believe that equity securities of a securities firm listed on one of these exchanges would substantially meet the quality standards of the rule; the twelve major Japanese securities firms have already been approved in three exemptive orders. Acquisitions of any such securities would be in compliance with the quantitative limits (subparagraphs (b)(1) and (3)) and any other requirements of the rule.

Law and Regulations

Section 12(d)(3) of the Investment Company Act prohibits a registered investment company from purchasing the securities of a broker-dealer, underwriter, or investment adviser ("securities firms"). Rule 12d3-1 thereunder is an exemptive rule which permits an investment company to purchase securities issued by securities firms under certain conditions. The rule creates a blanket exemption for securities of entities that derive less than 15 percent of their gross revenues from securities-related activities. Securities of entities that derive more than 15 percent of their gross revenues from securities-related activities may be purchased only if the following quantitative and qualitative standards are met.

The rule limits the amount of equity stock of a securities firm that an investment company can purchase to no more than 5 percent of the issuer's outstanding securities and to no more than 5 percent of the value of the investment company's portfolio (subparagraphs (b)(1) and (2)). In addition, at the time of acquisition, the security must meet a quality standard: an equity security must be listed as a "margin security" as defined in Regulation T of the Board of Governors of the Federal Reserve System (subparagraph (b)(4)); a debt security must be "investment grade" as determined by the board of directors of the acquiring company (subparagraph (b)(5)).

In the release adopting the rule, the Commission determined that it would impose these quality standards for two reasons -- because it was concerned about an investment company maintaining the liquidity of its portfolio, and it believed that such standards would lessen the harm from certain reciprocal practices between an investment company and a broker-dealer (IC-14036, July 13, 1984).

The current quality standards of Rule 12d3-1(b)(4) limit the permissible scope of the rule to the equity securities of U.S. issuers, because currently no equity securities of foreign issuers are listed by the Federal Reserve Board as margin securi-

ties. Since the exemptive rule does not permit the purchase of a foreign securities firm's equity stock, a registered investment company may not purchase any equity stock of a foreign broker-dealer or other foreign issuer that derives more than 15 percent of its gross revenue from a securities-related business without first obtaining individual exemptive relief under Section 12(d)(3). The lack of qualification of foreign issuers and the consequent detrimental effect on international investing by mutual funds precipitated our request that the Commission amend the rule, and is the occasion for our writing again today to request a no-action response until such time as the Commission is able to address the problem through rulemaking.

Equity Securities of Twelve Major Securities Firms in Japan

The Division has granted three exemptive orders to permit investment companies to purchase equity securities of the major broker-dealers in Japan: The Japan Fund, IC-14471, April 16, 1985 (notice) and IC-14432, March 20, 1985 (order); Daily Money Fund et al. IC-15325, September 25, 1986 (notice) and Fund, Inc. IC-15039, April 4, 1986 (notice) and IC-14077, April 30, 1986 (order). The twelve major companies are: Cosmo Securities Co., Ltd., Dai-ichi Securities Co., Ltd., Daiwa Securities Co., Ltd., New Japan Securities Co., Ltd., The Nikko Securities Co., Ltd., The Nippon Kangyo Kakumaru Securities Co., Ltd., The Nomura Securities Co., Ltd., Okasan Securities Co., Ltd., Sanyo Securities Co., Ltd., Wako Securities Co., Ltd., Yamaichi Securities Co., Ltd., and Yamatane Securities Co., Ltd., (collectively, the "Japanese securities firms").

In these exemptive applications, the applicants agreed to meet all the other conditions of Rule 12d3-1 except subparagraph (b)(4). Applicants represented, however, that the Japanese securities firms were of a size and quality comparable to U.S. securities firms which meet the requirement of subparagraph (b)(4). According to the applicants, the securities were listed on the Tokyo and Osaka Stock Exchanges whose listing standards were comparable to those for listing on the New York and American Stock Exchanges. In addition, the applicants represented that public documents about these firms were readily available to enable them to calculate and comply with the 5 percent limit on the purchase of a firm's outstanding securities. Applicants further agreed that they would monitor their assets to assure that no more than 5 percent of their value would be invested in a particular firm's securities. In granting these applications, the Commission implicitly agreed that these securities substantively meet the quality standards of the rule.

We request that the Division take a no-action response if other investment companies without individual exemptive orders purchase the equity securities of these twelve Japanese securities firms, as long as such acquisitions are in accordance with all requirements of the rule with the exception of subparagraph (b)(4).

We are requesting a no-action response also if investment companies acquire equity securities of foreign securities firms listed on any of the world's twelve major stock exchanges. The twelve are Amsterdam, Australia,** Brussels, Copenhagen, Germany,** London, Luxembourg, Milan, New York, Paris, Singapore, Tokyo, Toronto, and Zurich. These stock exchanges were cited as the world's major stock exchanges in a recent Commission staff report (Internationalization of the Securities Markets, July 27, 1987, II-65-66). The other two stock exchanges on the list were the American and New York Stock Exchanges and securities listed on these U.S. exchanges already qualify under subparagraph (b)(4) of the rule. We have attached the relevant pages from this report.

As mentioned above, for an equity security to qualify under the rule, it must be a "margin security" under Regulation T. Under Regulation T, equity securities automatically qualify as margin stock if they are listed on a U.S. national securities exchange. (Over-the-counter stocks may also qualify if they meet certain standards.) At present, there are few foreign issuers listed on U.S. exchanges. However, the Commission this summer issued a release permitting the American and New York Stock Exchanges to waive certain listing standards, such as composition and election of the Board of Directors and quarterly reporting of interim earnings, where there are conflicts in the laws and practices in the home market of the issuer. (Exchange Act Release No. 24634, June 23, 1987). This flexibility will likely facilitate the listing of foreign issuers on the New York and American Stock Exchanges.

Although this change has been instituted by the Commission, it will be a period of time before a significant number of foreign stocks become listed on the U.S. exchanges, and there is no guarantee that a stock of particular foreign securities firm will be one of these stocks. This action by the Commission acknowledges, however, that although listing standards may not be identical for each issuer, that they may be similar enough to guarantee a certain quality of security. We believe that listing on one of the other major world stock exchanges would also similarly ensure a certain depth of market and public availability of information about an issuer. This would alleviate the liquidity concerns cited by the Commission in adopting Rule 12d3-1 similarly to the protections in the rule relating to the equity securities of domestic securities firms.

Need for No-Action Relief

The equity securities of foreign securities firms provide attractive international investment opportunities for mutual funds. However, at present the only means of such investment is by individual exemptive order. This is an insufficient remedy

** Includes all exchanges in each respective country.

since it involves delays in an area where time, even a day, is a critical factor. The result is lost investment opportunities to the detriment of fund shareholders. Obtaining individual exemptive orders for foreign securities that substantively, if not technically, meet the standards of the rule is duplicative and costly to both the industry and the staff. Permitting investment companies to purchase the foreign equity securities which are the subject of this request will alleviate these burdens without impairing investor protection.

Conclusion

While we believe that the most effective and complete solution would be the rule amendment suggested in our April 29, 1987 submission, you have stated that the Division is already faced with a full regulatory agenda and that no recommendations to the Commission can be made for the requested rule amendment in the near future. We request, therefore, that pending Commission action to expand the scope of the rule to include the equity securities of qualified foreign issuers, the Division agree not to recommend enforcement action to the Commission if an investment company, without first obtaining an individual exemptive order, acquires the equity securities of any of the twelve Japanese securities firms named above, or of any foreign securities firm listed on one of the world's twelve major stock exchanges named above. Any purchase by an investment company of such securities would comply with the quantitative limits of the rule as well as any other requirements set forth in the rule.

We would be glad to provide any additional information requested and to meet you and your staff to discuss this request.

Very truly yours,



Susan P. Hart
Assistant General Counsel

Attachment

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RESPONSE OF THE OFFICE OF CHIEF COUNSEL
DIVISION OF INVESTMENT MANAGEMENT

Our Ref. No. 87-486-CC
Investment Company Institute
File No. 132-3

In your letter, dated August 24, 1987, you request our assurance that we would not recommend any enforcement action to the Commission under Section 12(d)(3) of the Investment Company Act of 1940 ("1940 Act") if, under certain circumstances and pending possible Commission action regarding Rule 12d3-1 under the 1940 Act, investment companies purchase equity securities of foreign broker-dealers or other foreign issuers that derive more than 15 percent of their gross revenues from securities related activities. Specifically, you request no-action relief under Section 12(c)(3) if investment companies purchase equity securities of either: 1/ one of the twelve major Japanese securities firms ("Japanese securities firms") that have already been the subject of exemptive orders regarding Rule 12d3-1; 2/ or (2) a securities firm listed on one of the stock exchanges referred to in your letter. 3/

You assert that, in both instances, an investment company's purchases of these equity securities would comply with the provisions of Rule 12d3-1 under the 1940 Act, except for the requirement in paragraph 12d3-1(b)(4) that the equity security be a "margin security" as defined in Regulation T of the Board of Governors of the Federal Reserve System. However, you assert that, for purposes of Rule 12d3-1, these equity securities exhibit the same attributes as a "margin security." Thus, you conclude that these equity securities would not pose the liquidity concerns cited by the Commission in adopting Rule 12d3-1.

1/ These twelve firms are: Cosmo Securities Co., Ltd.; Dai-ichi Securities Co., Ltd.; Daiwa Securities Co., Ltd.; New Japan Securities Co., Ltd.; The Nikko Securities Co., Ltd.; The Nippon Kangyo Kakumaru Securities Co., Ltd.; The Nomura Securities Co., Ltd.; Okasan Securities Co., Ltd.; Sanyo Securities Co., Ltd.; Wako Securities Co., Ltd.; Yamaichi Securities Co., Ltd.; and Yamatane Securities Co., Ltd.

2/ See Daily Money Fund et al., Investment Company Act Rel. No. 15325 (Sept. 25, 1986) (notice) and Investment Company Act Rel. No. 15363 (Oct. 20, 1986) (order); Merrill Lynch Pacific Fund, Inc., Investment Company Act Rel. No. 15039 (Apr. 4, 1986) (notice) and Investment Company Act Rel. No. 15077 (Apr. 30, 1986) (order); The Japan Fund, Inc., Investment Company Act Rel. No. 14432 (Mar. 20, 1985) (notice) and Investment Company Act Rel. No. 14471 (Apr. 16, 1985) (order).

3/ These stock exchanges are: Amsterdam, Australia (including all exchanges in that country), Brussels, Copenhagen, Germany (including all exchanges in that country), London, Luxembourg, Milan, New York, Paris, Singapore, Tokyo, Toronto, and Zurich.

With respect to the first part of your request, we would not recommend any enforcement action to the Commission under Section 12(d)(3) of the 1940 Act if, pending possible Commission action on Rule 12d3-1, investment companies purchase equity securities of the Japanese securities firms, as described in your letter. This position is based on the facts and representations contained in your letter.

With respect to the second part of your request, we are, at present, considering similar issues in the context of an application for exemptive relief. 4/ Because of the factual nature of this part of your request, especially the characteristics and requirements of particular stock exchanges (not all of which are covered by the pending application), we believe that this part of your request should be deferred pending staff consideration of the issues in the processing of applications for exemptive orders. For this reason, we decline to grant no-action relief at this time with respect to investment companies' purchases of equity securities listed on the stock exchanges referred to in your letter.

Mary S. Podesta

Mary S. Podesta
Chief Counsel

4/ See Application of Daily Money Fund et al., File No. 812-6587 (filed Dec. 31, 1986, amended Aug. 4, 1987 and Sept. 21, 1987).