SECTION 17 OF THE INVESTMENT COMPANY ACT—AN EXAMPLE OF REGULATION BY EXEMPTION

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I. Introduction

In a highly regulated society, it is inevitable that imprecise drafting will turn some laws into almost impenetrable mysteries, expressed in language so confusing and ambiguous that advance planning is not for the risk-averse. Some of these laws are celebrated—the "predatory pricing" provisions of the Robinson Patman Act,[1] for example—but others are known only within the circle of lawyers and managers who are unable to avoid the ambit of the statute. In the latter category rests section 17 of the Investment Company Act of 1940,[2] and particularly section 17(d). The clear purpose of the section, which is to prevent insider abuse,[3] has been compromised by the inelegant language selected by the draftsmen and the Securities Exchange Commission (SEC) staff. This article will examine the forty-year history of section 17(d) and analyze the many interpretations the section has acquired since its enactment.

The necessity for legislation governing investment companies was demonstrated in the course of the SEC study antedating passage of the 1940 Act.[4] SEC Commissioner Robert Healy described in his

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1. 15 U.S.C. § 13 (1982).

2. 15 U.S.C. § 80a-1 to -52 (1982) [hereinafter cited as the '40 Act].

3. *See infra* note 5 and accompanying text.

4. Sec, Report on the Study of Investment Trusts and Investment Companies (1939-1942). For a discussion outlining the purposes of § 17 of the '40 Act, see Comment, *The Application of Section 17 of the Investment Company Act of 1940 to Portfolio Affiliates*, 120 U. Pa. L. Rev. 983, 987 (1972) [hereinafter cited as Comment, *The Application of Section 17*]. As noted in the aforementioned article, the following articles provide a discussion of the Investment Company Act at the time of enactment. *See generally* Jaretzki, *The Investment Company Act of 1940*, 26 Wash. U.L.Q. 303 (1941); Thomas, *The Investment Company Act of 1940*, 9 Geo. Wash. L. Rev. 918 (1941); Comment, *The Investment Company Act of 1940*, 50 Yale L.J. 440 (1941); Note, *The Investment Company Act of 1940*, 41 Colum. L. Rev. 269 (1941); Federal Legislation, *Investment Company Act of 1940*, 29 Geo. L.J. 614 (1941); Note, *Regulation of Investment Companies*, 88 U. Pa. L. Rev. 584 (1940).

testimony the kind of abuse that section 17(d) (originally drafted as section 17(a)-4) was intended to cover:

> Investment companies have been compelled to finance banking clients of the insiders, and companies in which they were personally interested. Some investment companies are organized to be operated essentially as discretionary brokerage accounts, with the insiders obtaining the brokerage commissions. In many instances the abuses are more subtle but just as injurious to the investor. The public's funds are used to further the banking business of the insiders to obtain control of various industrial enterprises, banks and insurance companies, so that the emoluments of this control will flow to these controlling persons.[5]

Given that history, the broad outline of section 17 was easy to articulate. As the chief counsel for the SEC's study of investment trusts testified: "[T]his bill says that you cannot sit on both sides of the table when you are dealing with an investment trust."[6]

When it came time to draft the operative language, however, the bright lines began to fade. The draftsmen elected to encompass a wide range of activity when drafting the statutory provision, which read in 1940 essentially as it does today:

> It shall be unlawful for any affiliated person . . . of a registered investment company . . . or any affiliated person of such a person . . . acting as principal to effect any transaction in which such registered company, or a company controlled by such registered company, is a joint or a joint and several participant with such person . . . in contravention of such rules . . . as the Commission may prescribe for the purpose of limiting or preventing participation by such registered or controlled company on a basis different from or less advantageous than that of such other participant. . . .[7]

II. SECTION 17(a)

The loose contours of subsection (d) were, presumably, a conse-

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5. *Investment Company Act of 1940; Hearings on S.3580 Before a Subcomm. of the Senate Comm. on Banking & Currency*, 76th Cong., 3d Sess. pt. 1 at 37 (1940) [hereinafter cited as the Senate Hearing].

6. *Id.* pt. 1, at 130.

7. 15 U.S.C. § 80a-17d (1982).

quence of an intent to catch those transactions which escaped the prohibitions in earlier subsections, particularly subsection (a), against insiders buying or selling securities to or from an investment company's portfolio or borrowing money from the fund.[8] Because the distinction has been carelessly ignored on frequent occasions, it is important to keep in mind the intended difference between subsections (a) and (d). Section 17(a) is limited to a sale, purchase, or borrowing effected directly between an investment company and its affiliate.[9] Conversely, the transactions covered by section 17(d) and Rule 17(d)-1 thereunder are theoretically unlimited; any joint arrangement qualifies. Whereas section 17(a) contemplates the affiliate and the investment company facing each other across the table, section 17(d) envisions these parties on the same side of the table transacting business with a third party. While it may be clear to those drafting the two subsections that each contemplates coverage of a different kind of relationship, confusion has arisen because the definition of "joint enterprise, or other joint arrangement" contained in subparagraph (c) of Rule 17d-1 can be, and often has been read to include the transactions contemplated by section 17(a).[10] The overlap, as later discussed, has created complex problems.

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8. 15 U.S.C. 80a-17a (1982) which provides:

It shall be unlawful for any affiliated person or promoter of or principal underwriter for a registered investment company (other than a company of the character described in section 80a-12(d)(3)(A) and (B) [of this title involving underwriters owned entirely by investment companies—an exception not relevant for our purposes]), or any affiliated person of such a person, promoter, or principal underwriter, acting as principal—

(1) knowingly to sell any security or other property to such registered company or to any company controlled by such registered company, unless such sale involves solely (A) securities of which the buyer is the issuer, (B) securities of which the seller is the issuer and which are part of a general offering to the holders of a class of its securities, or (C) securities deposited with the trustee of a unit investment trust or periodic payment plan by the depositor thereof;

(2) knowingly to purchase from such registered company, or from any company controlled by such registered company, any security or other property (except securities of which the seller is the issuer); or

(3) to borrow money or other property from such registered company or from any company controlled by such registered company (unless the borrower is controlled by the lender) except as permitted in section 80a-21(b) of this title.

9. *See supra* note 5 and accompanying text. Section 17(a) and rule 17a-1 are not without their inherent anomolies. Rule 17a-3 exempts transactions between a registered company and a wholly owned subsidiary. Section 17(a)(3) exempts a loan from a fund to any "controlled" (i.e., as little as 26% ownership) company.

10. *See* Christiana Sec. Co., Investment Co. Act Release No. 8615 (Dec. 13, 1974); Meridian Investing & Dev. Corp., [1971-1972 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 78,657 (Aug. 31, 1971). Purchase by investment company of

III. RULE 17d-1

Typical of the Act's structure, it is not the statute which makes conduct unlawful but rather the rule or rules the Commission subsequently enacts. For example, an overly quick glance at section 12(a)(2)[11] of the statute might lead one to conclude that a registered company had violated the law if it maintains a "joint trading account." However, joint trading accounts are unlawful only if the Commission establishes a rule; since the Commission has never taken such action, joint trading accounts are not unlawful.

By contrast, the Commission promptly went about rule making under section 17(d). Rule 17d-1 currently provides:

> (a) No affiliated person of or principal underwriter for any registered investment company (other than a company of the character described in section 12(d)(3)(A) and (B) of the Act) and no affiliated person of such a person or principal underwriter, acting as principal, shall participate in, or effect any transaction in connection with, any joint enterprise or other joint arrangement or profit-sharing plan in which any such registered company, or a company controlled by such registered company, is a participant, and which is entered into, adopted or modified subsequent to the effective date of this rule, unless an application regarding such joint enterprise, arrangement or profit-sharing plan has been filed with the Commission and has been granted by an order entered prior to the submission of such plan or modification to security holders for approval, or prior to such adoption or modification if not so submitted, except that the provisions of this rule shall not preclude any affiliated person from acting as manager of any underwriting syndicate or

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securities of a real estate development firm, which was wholly owned by an affiliate of an affiliate of the investment company, would be exempt from provisions of § 17(a) by reason of rule 17a-6(b) promulgated pursuant to such section. Finding was based on the fact that no person having the relationship to the investment company described in the rule would be party to the transaction or have the required financial interest in a party. SEC staff also impressed by the fact that investment company would seek shareholder approval of plan to deregister under the Act. *The SEC did not agree that the proposed transactions would be exempt from 17(d), which refers to joint participation by investment companies and their affiliates in transactions, but did not recommend any action in view of circumstances.*

11. 15 U.S.C. § 80a-12(a)(2) (1982).

> other group in which such registered or controlled company is a participant and receiving compensation therefor.[12]

Several points present themselves upon initial reading of the rule. First, unlike most other sections of the securities laws, there is a "regulation by exemption" element on the face of the rule. While the bans in most regulatory schemes have an outlet in the form of a waiver or exemptive proceeding, economy of administrative resources suggests that requests for waivers usually are not favored. In this instance, however, it appears that the drafters of the rule intended it to encompass a wide variety of transactions, with the permissible to be separated from the impermissible on an *ad hoc* basis. Indeed, in earlier versions, the rule contemplated an automatic grant of an exemption if the staff had not responded negatively within ten days.[13]

While not commonplace in the securities laws, the regulation by exemption approach is occasionally used as a regulatory device, particularly where the rule maker is breaking new ground and is uncertain where to draw the line. However, this approach is not recommended by admirers of efficient administrative practice. Regulation by exemption tends to confuse those subject to such regulation, while unduly rewarding those firms with direct access to the agency. This ultimately results in a haphazard regulatory pattern.

IV. RULE 17d-1 v. SECTION 17(d)

Given its inauspicious framework, it is not surprising that a sense of confusion has endured from the date section 17 was enacted until today. Senator Taft set the tone:

> Frankly, it would take all afternoon to study Section 17 to find out what it means, before I begin to criticize it. You define what would be an affiliated person, or any affiliated person of such a person acting as principal; and then you say that no affiliated person of an affiliated person of a registered investment company shall sell any stock to the company. Is that the English of it? It is certainly pretty hard to understand what this section does prohibit and what it does not.[14]

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12. 17 C.F.R. § 270.17(d)-1(a) (1980). The underlined words are those added since the rule's enactment.

13. SEC Investment Co. Act Release No. 858 (Feb. 6, 1946).

14. Senate Hearing, *supra* note 5, pt. 1, at 261.

Similarly, one commentator has observed that "[s]ection 17(d) and Rule 17d-1 thereunder seem to me to be a morass of unascertainable depth."[15] In addition, Phillip Loomis, a former SEC Commissioner, has confessed: "I want to point out that § 17(d) is a rather peculiar section. I'm not sure that I understand it."[16]

One of the anomalies of the rule is that it has a wider scope than the section upon which it is based. Section 17 applies to "*transactions effected* by affiliates"[17] in which the investment company or controlled company is a joint or joint and several participant, clearly requiring both a transaction and an active role by the affiliate in effecting that transaction. Rule 17d-1(a), however, puts the prohibition in the alternative. The rule provides that the designated affiliates acting as principals shall not "participate in, *or* effect any transaction in connection with, any joint enterprise, or other joint arrangement or profit sharing plan. . . ."[18] The rule apparently covers those cases in which the affiliate merely participates in the joint enterprise as well as those cases in which the affiliate is an active mover.

The SEC may have further extended the scope of the section when it prohibited the insider from participating in or effecting a transaction "*in connection with* any joint enterprise or other joint arrangement or profit sharing plan. . . ."[19] These terms have been defined broadly and include "any written or oral plan, contract, authorization or arrangement, or any undertaking whereby a registered investment company or a controlled company thereof and any [listed insider] have a joint or joint and several participation, or share in the profits . . . ."[20] One commentator[21] has remarked that the phrase "in con-

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15. Kroll, *The Portfolio Affiliate Problem*, THIRD ANN. INST. ON SEC. REG. 261 (1972) [hereinafter cited as Kroll].

16. *Id.* at 286.

17. 15 U.S.C. § 80a-2(a)(3) (1982) provides:

> "Affiliated peson" of another person means (A) any person directly or indirectly owning, controlling, or holding with power to vote, 5 per centum or more of the outstanding voting securities of such other person; (B) any person 5 per centum or more of whose outstanding voting securities are directly or indirectly owned, controlled, or held with power to vote, by such other person; (C) any person directly or indirectly controlling, controlled by, or under common control with, such other person; (D) any officer, director, partner, copartner, or employee of such other person; (E) if such other person is an investment company, any investment adviser thereof or any member of an advisory board thereof; (F) if such other person is an unincorporated investment company not having a board of directors, the depositor thereof.

18. *See supra* note 9 and accompanying text.

19. *Id.* (emphasis added).

20. 17 C.F.R. § 270.17d-1(c) (1983).

21. 2 T. FRANKEL, THE REGULATION OF MONEY MANAGERS 514-54 (1978).

nection with" connotes a broader coverage than the word "with" as used in section 17:

> The investment company need not be a participant in the transaction that brings the Rule into play. It must be a participant in the plan furthered by the transaction, but it need not necessarily participate with the affiliate. The investment company and the affiliate must be joint or joint and several participants in the enterprise or, alternatively, in the profit-sharing plan. Thus, the "togetherness" between the investment company and the affiliate may be twice removed from the transaction and may be manifested by a shared interest in profits.[22]

In short, the term "transaction," at the core of the requirements for a section 17 violation, assumes lesser importance in Rule 17d-1. While section 17(d) prohibits the affiliate from effecting a transaction in which the investment company is a participant, Rule 17d-1 seemingly prohibits the affiliate from participating in joint enterprises, joint arrangements, or profit-sharing plans with the investment company, and from effecting any transactions that might be deemed to further such enterprises because they are "in connection with" them. The shift in focus from transactions effected by the affiliate with the investment company's participation, to transactions effected by the affiliate which might somehow further some unspecified joint enterprise or profit-sharing plan in which the investment company's "participation" may be purely advantageous, represents a substantial broadening of the statutory coverage.

The enlarged scope of Rule 17d-1 did not go unchallenged. The defendants in *Securities & Exchange Commission v. Talley Industries, Inc.*[23]

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22. *Id.* at 536.

23. 286 F. Supp. 50 (S.D.N.Y. 1968), *rev'd*, 399 F.2d 396 (2d Cir. 1968), *cert. denied*, 393 U.S. 1015 (1969). *Talley* was concerned with an action brought under § 17d of the Investment Company Act of 1940 and the SEC rule promulgated thereunder, 17d-1. Specifically, whether an investment company and an affiliate had been joint participants in a plan to acquire enough shares of a target corporation to enable the affiliate to effect a merger with the target.

The court of appeals, per Chef Justice Friendly, held that there was substantial evidence to support the Commission's finding that the investment company and its affiliate had acted jointly when acquiring the shares of a third company and that such activity violated the Commission's rules. 399 F.2d at 403, 404.

During the course of their opinion in *Talley*, the court of appeals enunciated the following rationale for prohibiting joint enterprises between investment companies and their statutorily defined affiliates (15 U.S.C. § 80-2(a)(3)): "The objective of § 17(d) of the Investment Company Act is to prevent affiliated persons from injuring the interest of the stockholders of registered investment companies by causing the

attacked it vigorously. However, Judge Friendly dismissed their challenge, observing that "little purpose would be achieved by tired-eye scrutiny of the word 'transaction' . . . the real issue concerns the phrase 'is a joint or a joint and several participant.'"[24] Hence, for Judge Friendly, the critical question under the rule and the section was the same.[25]

The defendants in *Talley* also challenged the advance application procedure required by rule 17d-1, asserting that section 17(d) empowered the commission to adopt substantive rules only and was not a procedural mechanism for prior testing of a transaction.[26] However, Judge Friendly upheld the Commission's position. He observed that the variety of participations by an investment company in transactions to its disadvantage were infinite and that the Commission could well have concluded that "[a]n attempt to specify these might fail to accomplish the Congressional purpose in some instances and in others accomplish more than Congress desired, and that the only effective method of regulation was to require advance disclosure and individual decision, at least until a pattern emerged."[27] Evidently, a clear pattern has never emerged, because the advance approval approach has yet to be rejected.

Another feature of regulation by exemption is that there is an abundance of opinion interpreting the rule, but most of the opinions are self-serving announcements of the Agency's staff in unopposed proceedings. Thus, in the case of section 17, there are relatively few court pronouncements, "[m]ost of the cases being SEC opinions of unper-

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company to participate on a basis different from or less advantageous than that of such other participant." 399 F.2d at 405. *See supra* note 8.

In other words, the Act sought to protect the "interest of investors [who] are adversely affected * * * when investment companies are organized, operated, managed, or their portfolio securities are selected, in the interest of directors, officers, investment advisors, depositors or other affiliated persons thereof * * * rather than in the interest of all classes of such companies' security holders." *Id.* at 402.

24. 399 F.2d at 402.

25. *Id.* at n.5 which states:

> We thus find it unnecessary to discuss the issue, much debated by the parties, whether the SEC went beyond the statute when it added the words in Rule 17d-1(a), "in connection with, any joint enterprise or other joint arrangement or profit-sharing plan. . . ." In defining these terms subdivision (c) requires that the affiliate and the investment company "have a joint or a joint and several participation" or—not there contended—"share in the profits of such enterprise or undertaking." Hence, as to this case the critical question under the Rule is the same as under the statute.

26. *Id.* at 404.

27. *Id.*

suasive authority."[28] To quote one observer, the staff's opinions in granting exemptions have been characterized, especially in more recent years:

> by dry recitations of the facts presented in the applications for exemption, followed by psittacistic findings of compliance with the applicable standards for exemption. The applications are very often unopposed, and in the occasional cases where a jurisdictional challenge might be appropriate (on the grounds, for example, that Section 17 did not apply to the transaction proposed, or that statutory affiliation was not present) it is very often disregarded altogether by the applicant or raised only lukewarmly.[29]

While Judge Friendly in *SEC v. Sterling Precision Corp.*[30] observed that uncontested administrative construction of this nature carries relatively little weight,[31] it nonetheless has precedential value for the staff. Therefore, the following discussion does not generally distinguish between court decisions, significant SEC opinions, and no-action positions.

Whatever the defects in the structure of Rule 17d-1, after years of frequent interpretation some patterns have begun to emerge. At this point, an examination of some of the more common issues will illustrate the limits of the apparently unbounded proscription. The key issue is the definition of the words "joint enterprise" and "joint arrangement" as applied to various fact patterns.[32] The SEC has defined the terms but in a largely circular fashion. An "arrangement," in

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28. Comment, *The Application of Section 17, supra* note 4, at 987.

29. *Id.*

30. 393 F.2d 214 (2d Cir. 1968) (*Sterling* dealt with the effect of § 17(a) of the '40 Act, on a non-*pro rata* redemption of a company's debentures which happened to be held by the registered investment company to whom the redeeming corporation was affiliated). *See supra* note 8.

31. 393 F.2d at 220. Fishgold v. Sullivan Drydock & Repair Corp., 328 U.S. 275, 290 (1946); Skidmore v. Swift & Co., 323 U.S. 134, 140 (1944). *Cf.* Volkswagenwerk Aktiengesellschaft v. FMC, 390 U.S. 261 (1968) (holding that:

> [t]he construction put on a statute by the agency charged with administering it is entitled to deference by the courts, and ordinarily that construction will be affirmed if it has a reasonable basis in law' . . . [b]ut the courts are final authorities on issues of statutory construction . . . and 'are not obliged to stand aside and rubber-stamp their affirmance of administrative decisions that they deem inconsistent with a statutory mandate or that frustrate congressional policy underlying a statute.'

Id. at 272 (citations omitted).

32. *See infra* notes 73-78 and accompanying text.

the language of Rule 17d-1(c), means among other things an "arrangement."[33] It can be "written or oral."[34] It includes, of course, "contracts" and it also includes a "plan [or] authorization."[35] Of minor note is the fact that the defined terms do not include an "undertaking" in the principal definition but do include a "practice . . . concerning an . . . undertaking." These definitions offer little substantive guidance and most courts have wisely avoided reliance upon them. Analysis of the issue must therefore proceed on a category-by-category basis.

V. TYPICAL CASES

A. *Parallel Purchases*

A recurring fact pattern in section 17(d) cases is a parallel investment in securities by both the affiliate and the fund in a third entity, very often a portfolio affiliate. The courts and the staff have been asked in a number of cases to determine if parallel investment constitutes a "joint enterprise . . . or arrangement" for purposes of section 17(d). The first and still leading decision applying section 17(d) and Rule 17d-1 to parallel investments is *SEC v. Midwest Technical Development Corp.*[36] In that case, the Commission charged that the directors of Midwest, a closed-end investment company, were guilty of gross abuse of trust in connection with investments which the directors and Midwest made within a short period of time in the same portfolio companies.[37] The court concluded that, although the directors had not committed a gross abuse of trust, their conduct did constitute a violation of section 17(d) sufficient to entitle the Commission to limited injunctive relief.[38]

The court's initial consideration of the legislative history and purpose of the Act led to the conclusion that the term "joint venture" or "joint enterprise" should be given a broad and inclusive interpretation.[39] The court later made it clear, however, that even a

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33. 17 C.F.R. § 270.17d-1(c) (1980).

34. *Id.*

35. *Id.* Of minor note is the fact that the defined terms do not include an "undertaking" in the principle definition but do include a "practice . . . concerning an" undertaking.

36. [1961-1964 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 91,252 (D.C. Minn. July 5, 1963).

37. *Id.* at 94,137, 94,139-45.

38. *Id.* at 94,136, 94,155.

39. *Id.* at 94,145.

broad interpretation would not include a mere coincidental investment, noting that the mere parallel action of an investment company and its directors investing in portfolio companies surely is not within the proscription of the act or the regulations.[40] In this case, however, the court was condemning a *pattern* frequently followed by the directors in capitalizing on Midwest investments by strengthening their own personal investments in portfolio stocks without obtaining the approval of the Commission.[41]

Significantly, the court distinguished the instant case from those involving directors of large investment funds trading in securities of corporations qualifying on the national securities exchanges.[42] In the latter instance, the trading by the fund would not affect the price of the stock significantly and, therefore, the court concluded there would be little opportunity for manipulation by affiliates.[43]

It did not take the Commission long to impose its own expansive interpretation upon the "pattern of conduct" test applied by the court in *Midwest Technical*. In *Imperial Financial Services, Inc.*,[44] the Commission found a pattern of conduct to exist based on just two instances of an investment company and an affiliate undertaking to invest in the same issuer at about the same time.[45] The *Imperial* opinion is silent as to whether the companies in which both the investment company and the affiliate traded were listed on the exchange, but the case did indicate that the size of the investments was substantial.[46]

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40. *Id.* at 94,154.
41. *Id.* at 94,146.
42. *Id.* at 94,147.
43. *Id.*
44. 42 S.E.C. 717 (1965).
45. *Id.* at 727. The court states:

> In the instant case we do not have the mere happenstance of simultaneous ownership of the same securities by an investment company and affiliated persons. On the contrary, in two instances Imperial and affiliated persons of Imperial undertook at or about the same time to invest in the same companies at the inducement or arrangement of the same persons. Section 17(d) seeks to prevent affiliated persons of a registered investment company from taking undue advantage of the investment company in transactions in which such persons and company participate in a joint undertaking. The possibility that the investment company was not disadvantaged does not cure the unlawfulness of proceeding with the joint enterprises without obtaining the prior approval of this Commission as required by Rule 17d-1. Accordingly, we find that the affiliated persons were joint participants with Imperial in the National and Eagle Wash transactions in violation of Section 17(d) and rule 17d-1.

Id.

46. *Id.* at 726.

B. *Parallel Investments in Light of Rule 17j-1*

Coincident investments by a director and a fund presents a difficult question. On the one hand, a strict fiduciary standard might suggest that the directors should be completely prohibited from making personal investments in the fund's stocks. On the other hand, some fund management groups feel that management itself, including the directors, should invest in the same securities that they advise their funds to invest in. If the directors are willing to put the fund's money into IBM, for example, shouldn't they also be willing to invest their personal dollars? The issue is partially resolved by the Code of Ethics provisions adopted by all funds pursuant to Rule 17j-1 of the 1940 Act,[47] and it is likely that enforcement action and litigation can be avoided in the future by those managements who pay strict attention to the Code.

Rule 17j-1 requires registered investment companies to adopt a code of ethics to govern transactions[48] entered into by officers and interested directors,[49] as well as noninterested directors, for their own accounts in securities in which the fund is also buying or selling.[50] The rule, however, is quite specific with respect to what provisions the Code of Ethics should contain; it mandates prior notification by all officers and interested directors, and trading outside of a fifteen-day "window" guarding both sides of the fund's trades.[51] The noninterested directors must abstain only when they know or should have known the fund was planning a trade or had traded.[52] To protect outside directors with active stock portfolios, management is compelled to contrive ways of keeping them in the dark about what the fund is planning to do or is doing until the window closes down.

The effect of the Code on cases similar to *Midwest Technical* is uncertain.[53] If a director waits for fifteen days after the fund has made a private purchase of restricted securities to make his purchase, and this pattern of conduct is repeated a number of times, presumably

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47. 17 C.R.F. § 270.17j-1 (1980).
48. *Id.* at § 270.17j-1(b)(1).
49. *Id.*, at § 270.17j-1(e)(1)(i).
50. *Id.* at § 270.17j-1(e)(1)(ii), (iii).
51. *Id.* at § 270.17j-1(e)(6).
52. *Id.* at § 270.17j-1(c)(e)(ii).
53. *See supra* notes 36-43 and accompanying text discussing *Midwest Technical* wherein the court condemned a pattern of individual investments by directors of an investment company which closely tracked the portfolio choices made by the investment company as being violative of § 17(d) since prior approval of the Commission was not obtained.

the Commission would feel free to address the issue regardless of Code compliance.

C. *Takeover Bids*

A frequent problem of current note involves the purchase of shares by a fund parallel to another entity when a takeover bid is in progress. The leading judicial statement on the applicability of section 17(d) to mutual funds involved in takeover bids is found in *General Time Corp. v. American Investors Fund, Inc.*[54] This decision and related litigation[55] resulted from the acquisition by Talley Industries and American Investors Fund of General Time Corporation stock preparatory to Talley's takeover of General Time.[56] Investors Fund and Talley were affiliated under the Act because the Fund owned over five percent of Talley's outstanding stock.[57] When Talley began its acquisition of General Time shares on the open market, it communicated its intention to the Fund.[58] The Fund then conducted its own investigation and evaluation of General Time and bought a substantial number of its shares, based primarily on the prospects of success of the proposed merger.[59] The concurrent purchases, on the advice of the Fund's counsel, were effected without any oral or written agreement between it and Talley as to the purchase or the subsequent voting of shares at the annual stockholders meeting of General Time.[60]

General Time brought an action against Talley and the Fund alleging, *inter alia*, violations of section 17(d) and Rule 17d-1.[61] Judge Bryan dismissed the suit, concluding that General Time lacked standing to complain of the violation since Congress intended the Investment Company Act to protect shareholders of investment companies and not corporations whose securities might be acquired by such investment companies.[62] Although the decision was affirmed on other grounds,[63] Second Circuit Judge Friendly later expressed his agreement with Judge Bryan's determination.[64] The significance of the court's

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54. 283 F. Supp. 400 (S.D.N.Y. 1968).
55. *See infra* notes 92-100 accompanying text.
56. 283 F. Supp. at 401.
57. *Id. See* 15 U.S.C. § 80-2(a)(3)(B) (1982).
58. 399 F.2d at 399.
59. *Id.*
60. *Id.*
61. 283 F. Supp. at 401.
62. *Id.* at 402.
63. General Time Corp. v. Talley Indus., Inc., 403 F.2d 159(2d Cir. 1968).
64. SEC v. General Time Corp., 407 F.2d 65, 70-71 (2d Cir. 1968).

holding on the standing issue is twofold. First, this weapon is removed from the arsenal of defensive measures a target company can employ in a takeover attempt, at least in the Second Circuit.[65] Secondly, in holding that the target lacks standing, Judge Bryan and later Judge Friendly intimated that someone who could claim an injury cognizable under the Act, i.e., a shareholder, would be a proper party to bring an action under section 17(d).[66]

Following dismissal of General Time's suit, and in the course of the ensuing proxy battle, Talley applied under Rule 17d-1(b) for an exemptive order for its already concluded acquisition of General Time shares.[67] The SEC is customarily hesitant to grant retroactive exemptions,[68] and this case proved no different as the application was denied.[69] Nonetheless, Talley voted the shares.[70] The SEC accepted the challenge and filed suit under section 17(d) of the Act, seeking the withdrawal of the Talley votes cast.[71]

At the district court level, the action was dismissed.[72] On appeal, Judge Friendly had little trouble rejecting the notion, accepted by the district court, that Rule 17d-1 went beyond the scope of section 17(d).[73] He felt that the issue under the section and under the Rule was really the same—whether the Fund and the affiliate "have a joint or a joint and several participation or . . . share in profits of such enterprise or such undertaking."[74]

Judge Friendly also took issue with the district court's narrow interpretation of the phrase "joint or joint and several participation." However, he stopped short of holding that the mere coincidental or

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65. Recently a violation of § 17(a) and (d) has been used by a target company in asserting a claim against the raiding company under the Racketeering Influence and Corrupt Organization Act, 18 U.S.C. § 1961-1968. Counsel argued in its brief in support of its motion for a preliminary injunction that the proceeds to be used to purchase shares of the target company were obtained in part through transactions violating § 17(a) and (d) of the '40 Act. Counsel further argued that these violations were part of the "pattern of racketeering activity" required under the statute. *See* Dan River, Inc. v. Icahn, No. 82-0162-D (W.D. Va.).

66. 407 F.2d at 71.

67. *In re* Talley Indus., SEC Inv. Co. Act Release No. 5358 (Apr. 19, 1968).

68. Its concern, of course, is that companies otherwise might act first and seek exemption later, if anyone happened to notice and challenge.

69. *In re* Talley Indus., SEC Inv. Co. Act Release No. 5358, at 3 (Apr. 19, 1968).

70. SEC v. Talley Indus., Inc., 286 F. Supp. 50, 52 (S.D.N.Y. 1968), *rev'd*, 399 F.2d 396 (2d Cir. 1968), *cert. denied*, 393 U.S. 1015 (1969).

71. *Id.*

72. *Id.* at 60.

73. 399 F.2d at 402. *See supra* notes 14-22 and accompanying text.

74. *Id.*

parallel purchase by a fund and its affiliate would be a "joint enterprise" when he noted that even with a liberal interpretation of the term, some element of combination is required.[75] Such a combination could be inferred here because the Fund's purchase on Talley's recommendation, and the subsequent expenditure by Talley of over $800,000 in making further acquisitions at prices exceeding 150% of that paid by the Fund, did not, under normal industry custom, leave the Fund completely free to act with respect to its own shares.[76] As Judge Friendly observed: "[I]ndeed, developments may well have brought Industries and Fund into a 'combination' not clearly envisioned by either at the outset; war and the threat of war have always been powerful forgers of alliances."[77]

Judge Friendly also demonstrated his sensitivity to an issue which has been the subject of much controversy. He admitted that the need for a liberal construction would have been much clearer if, for example, Talley had been an affiliate because of its holding of 5% or more of the voting securities of the Fund or, in other words, if Talley had been an "upstream" affiliate of the Fund.[78] Judge Friendly cited *Midwest Technical* as a case involving abuse by upstream affiliates. Yet, he noted that Congress "could have thought that downstream affiliation also involves some danger that the investment company's shareholders might be put upon for the benefit of other shareholders of the affiliate."[79]

Congress "could have thought" as Judge Friendly suggests, but a review of the legislative history indicates that it probably was not contemplated by the legislature. Only once in the voluminous pages of testimony was there any reference to the possibility of abuse of affiliates by investment companies.[80] Both David Schenker of the Commission and Senator Taft agreed that any overreaching of a portfolio affiliate would result in action under state corporate law.[81] Schenker only argued for the need for an agency to publish such transactions.[82] Earlier in his testimony, when pressed by the Committee to explain the parameters of the rule, Schenker declared that section 17 was

75. *Id.* at 403.
76. *Id.* 404.
77. *Id.*
78. *Id.* at 402-03.
79. *Id.*
80. *See infra* notes 81 and 82.
81. Senate Hearing, *supra* note 5, pt. 1, at 264.
82. *Id.*
at 257-59.

directed exclusively to regulating transactions between an investment trust and its fiduciaries.[83]

It is significant that at two points in his discussion Judge Friendly makes reference to footnote seven in which he takes note of the Commission proposal[84] to modify Rule 17d-1 "to provide more precise standards for the determination whether and when an application must be filed."[85] Perhaps this explains his willingness to construe the term "joint enterprise" so loosely and to focus on downstream transactions. However, the Commission did not adopt the principal exemption until 1974.[86]

Judge Friendly remanded the case to the district court for the issuance of an injunction.[87] General Time ultimately appealed from the district court's entrance of a permanent injunction.[88] The appeals court held that General Time lacked standing, but it also confirmed the propriety of the lower court's refusal to rescind Talley's and the Fund's vote of their General Time Corporation shares at the 1968 annual meeting of General Time shareholders.[89] In the court's view, requiring withdrawal of the voting of the shares would have forced the Fund to liquidate its holdings to its disadvantage, running counter to the section's purpose of protecting the investment company's shareholders.[90]

Significantly, the decree of the district court stated that the continued voting of the shares by Talley and the Fund would not be regarded as a "joint transaction" provided there was no consultation or communication between Industries and the Fund.[91]

Another significant case with respect to tender offers is *Wellman v. Dickinson*,[92] in which Judge Carter found a clear violation of the section. The *Wellman* case arose out of the acquisition by Sun Company of thirty-four percent of the stock of Becton, Dickinson & Com-

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83. *Id.*al at 256.

84. SEC Inv. Co. Act Release No. 5128 (Oct. 13, 1967).

85. 399 F.2d at 403 n.7, 404. Notice of Proposal to Adopt a Revision of Rule 17d-1 Requiring Applications for Transactions in which Investment Companies Participate With Affiliated Persons, Investment Co. Act. Release No. 5128, [1966-1967 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 77, 477, at 82,948 (Oct. 13, 1967).

86. 17 C.F.R. § 270.17d-1(d)(5) (1983).

87. 399 F.2d at 406.

88. SEC v. General Time Corp., 407 F.2d 65 (2d Cir. 1968), *cert. denied* 393 U.S. 1026 (1969).

89. *Id.* at 70.

90. *Id.* at 67.

91. *Id.* at 68.

92. 475 F. Supp. 783 (S.D.N.Y. 1979), *aff'd*, 682 F.2d 355 (2d Cir. 1982), *cert. denied*, 103 S. Ct. 1522 (1983).

pany in a "brilliantly designed lightning strike" in January 1978.[93] F. Eberstadt & Co., Inc., along with Salomon Brothers, handled the Becton, Dickinson acquisition for Sun and controlled two funds which tendered stock to Sun.[94] The SEC and many others, including Becton, Dickinson, brought a multitude of actions, which were ultimately consolidated, against the successful bidder and related parties. The SEC's enforcement action against Sun, Eberstadt, Salomon, and others contended that Eberstadt and other affiliates had violated sections 17(d) and (e) of the Act.[95]

The court found that "the funds were joint and several participants in the Sun transaction because Eberstadt's chief executive officer had involved the funds in the transaction from the outset."[96] Eberstadt, frequently through its chief executive officer, had indicated to a series of suitors, including Sun, that the funds' Becton, Dickinson stock would be available.[97] This officer offered testimony that on all occasions he made it clear that he could not speak for the funds, but the court found otherwise.[98] There was simply no evidence that the funds independently reached their decision to tender the shares. The record demonstrated that the directors were asked to give their approval to the sale of an unidentified stock in the funds' portfolio to an unknown purchaser for an unknown price with only the knowledge that there would be a substantial premium.[99] Citing the record, the court observed that "this was the first time the directors of either fund had been asked to approve a sale of a portfolio security on a blind basis."[100]

D. *Recent Decisions*

Two fairly recent decisions[101] at the district court level, to the extent that they can be viewed as evidencing a judicial perspective, appear to take a somewhat restrictive view as to what is an enjoinable "transaction" for the purposes of section 17(d).

In *Bloom v. Bradford*,[102] the plaintiff argued that since prior SEC

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93. *Id.* at 790.
94. *Id.*
95. *Id.*
96. *Id.* at 836.
97. *Id.* at 800.
98. *Id.* at 815.
99. *Id.* at 814.
100. *Id.* at 815.
101. Bloom v. Bradford, 480 F. Supp. 139 (E.D.N.Y. 1979); Cambridge Fund, Inc. v. Abella, 501 F. Supp. 598 (S.D.N.Y. 1980).
102. 480 F. Supp. 139 (E.D.N.Y. 1979).

approval had not been obtained, the concurrent purchases of Penn Central stock by three mutual funds with interlocking directorates and a common investment advisor was a "joint enterprise" in violation of section 17(d).[103] The trial court rejected this argument, however, noting that section 17(d) requires an intentional act of agreement or at least a consensual pattern; the mere purchase or sale of securities on the open market by distinct investment companies is not enough. The court did not elaborate on what facts would constitute a consensual pattern. However, the fact that the transactions at issue were consistent with the investment objectives of the various funds seemed to play an important part in the court's decision.[104]

The most recent decision involving section 17(d) and a parallel purchase is *Cambridge Fund, Inc. v. Abella*,[105] in which Abella an officer and director of an investment company made four separate purchases of stock in companies in which the investment company had or would soon have a much larger position.[106] Although two subsequent resales of some of the shares netted him $4,028 and $1,019 in profits,[107] the court held that no violation of section 17(d) had occurred. The court ruled that these transactions were *de minimis*, although it did not explain why a low level of realized profits necessarily reflects upon the looseness or tightness of the alleged combination.[108]

A final aspect of the parallel purchase problem is evident in situations where the management of an internally managed investment company attempts to supplement its income by serving as an advisor to discretionary advisory accounts. Whether or not section 17(d) applies to concurrent investments by the company and its discretionary accounts in the securities of an issuer is an important question which has been raised in two no-action requests.

In *General American Investors Co.*,[109] an investment company advised three outside accounts, two of which were corporate pension funds. To comply with ERISA requirements, it registered as an investment advisor. In its letter of inquiry, the investment company noted that its general policy was to cause the managed funds to invest in some of the same securities as the company itself.[110] In its no-action re-

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103. *Id.* at 145.
104. *Id.* at 142.
105. 501 F. Supp. 598 (S.D.N.Y. 1980).
106. *Id.* at 612.
107. *Id.*
108. *Id.* at 630.
109. [1975-1976 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 80,344, at 85,918 (Aug. 28, 1975).
110. *Id.* at 85,919.

quest, it sought a staff position on certain disclosure requirements of the Investment Advisors Act without mentioning section 17(d).[111] The staff nonetheless commented on the potential applicability of that section, although they declined to take a firm position.[112] However, when the same issue arose again, the staff took a clear position that section 17(d) applied.

In *OTF Equities*,[113] a registered investment company proposed to act as an investment advisor to other investment companies. As part of the investment advisory arrangement, the company planned to invest concurrently with the investment companies it advised in the securities of the same issuers. The staff found that this was clearly a joint arrangement within the meaning of Rule 17d-1(c), so that an order from the Commission approving the plan was required.[114] The staff then listed four factors it would consider in connection with an application for an order: the degree of independence of the advisees from the advisor, the degree of authority of the advisor to make investment decisions for the advisees, whether all investments are to be shared, and the basis for sharing.[115]

In *OTF Equities*, the company and its advisees had apparently entered into a formal agreement concerning the concurrent investments.[116] The applicability of section 17 remains uncertain when the fund and the accounts it advises occasionally invest in the same securities, but do not do so pursuant to a formal agreement. In such a situation, the necessary joint arrangement may not be found to exist.

The parallel purchase problem is complex but usually soluble, as the fund generally has other options available for investment. The difficulty with the Rule in other contexts is that, if read literally, there may be no way to escape a violation. To illustrate, the Sherman Act

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111. *Id.*

112. The staff noted:

> In the course of our consideration of this question, we have also had occasion to reconsider the legality of the Fund's practice of providing investment advise to other persons, and we now believe that there may be problems of compliance arising under Section 17(d) of the Investment Company Act of 1940 and Rule 17d-1 thereunder in situations where the fund invests in the same securities as the advisory accounts over which the Fund exercises discretionary authority. Although we will not raise any objection to the practice at this time, we are presently reexamining this matter, and we may communicate with you further concerning it.

Id. at 85,921.

113. Available December 14, 1975.

114. *Id.*

115. *Id.*

116. *Id.*

declares contracts in restraint of trade unlawful.[117] The obvious problem is that all commercial contracts are in restraint of trade, hence a rule of reason must apply.[118] With respect to section 17(d), joint arrangements between affiliates are barred. However, the act or status of affiliation necessarily involves a joint arrangement, therefore, it follows that all affiliations should be barred. Since that would leave investment companies without directors, officers, or advisors, it is clear that some other definition must be applied to meet the practical realities of the marketplace.

One approach which could offer insight on the issue is to review the various decisions involving the Steadman Security Corporation, which managed a group of mutual funds and was wholly owned by Charles Steadman. Steadman and the management company engaged in a long continued practice of borrowing heavily from banks in which the various mutual funds had accounts. The SEC brought an action against Steadman claiming, *inter alia*, that Steadman used the custodian accounts of the funds to obtain bank loans and brokerage commissions in violation of section 17(d) and Rule 17d-1.[119]

Steadman prevailed at the administrative level, at least with respect to the section 17(d) issue, since the Administrative Law Judge was unable to discern a joint venture for profit.[120] On appeal to the full commission, the Investment Company Institute (ICI) submitted an amicus brief[121] disputing the Division's assertion that section 17 must be interpreted broadly as an open-ended enforcement section intended to reach every conceivable conflict of interest. Instead, the ICI asserted that section 36(a) adequately performed that task.[122]

The ICI also supported the Administrative Law Judge's finding that a joint venture for profit is required by section 17(d). It noted that section 17(d) was intended to limit or prevent participation by

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117. 15 U.S.C. §§ 1-7 (1982).

118. *See* Standard Oil Co. v. United States, 221 U.S. 1, 58-65 (1911).

119. *In re* Steadman Security Corp., [1974-75 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 80,038 (Dec. 20, 1974).

120. *Id.* at 84,848.

121. See [1974-1975 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 80,170, at 85,316 (May 1, 1975), for a summary for the ICI's brief.

122. According to the Institute, it is Section 36(a) of the Investment Company Act which was designed to permit the Commission to deal with subtle and ever-changing abuses between investment Companies and their affiliates. Section 36(a) authorizes the Commission to bring judicial proceedings to challenge any alelged "breach of fiduciary duty involving personal misconduct." Therefore, it is Section 36, and not Section 17(d), which is the open-ended enforcement section of the Investment Company Act.

Id.

an investment company on a basis different from or less advantageous than that of the other participant.[123] How then, ICI queried, could the section apply when the investment company and the affiliate were seeking to obtain totally different banking services. The ICI vigorously asserted that an alliance between the investment company and its affiliate on the same side of a transaction entered into for profit must necessarily exist in order for the section to apply.[124]

In its opinion, the Commission fashioned a "causal nexus" test for three party transactions.[125] If the loans were a *quid pro quo* for the deposits, or vice versa, then the "combination" required by *Talley* would be present.[126] The funds would be considered as participants because the use of their assets "would have been so significant a part of the total transaction."[127]

Clearly, this causal nexus test is limited to cases involving facts similar to those in *Steadman* and does not apply to situations, such as *Talley*, where the principal actors were the fund and the affiliate, and there was no requirement that the third party know of the combination. In *Steadman* there could be no causal connection without the active knowledge and participation of the third party bank.

The Commission held that the causal nexus or connection could be inferred from circumstantial proof, but stated that it could not, on this record, draw such an inference between the loans to Steadman and deposits of the funds.[128] This was a rather curious finding in light of the fact that the bankers had conceded in their testimony that the amounts a company has on deposit affects the interest rates on loans to that company.[129] In any event, a finding against Steadman on this point would have been unnecessary because he was clearly liable on a nondisclosure allegation.

It is difficult to predict the precedential value of the *Steadman* decision. The Commission was quick to note in its decision that the causal nexus test does not apply in the typical parallel investment situation.[130] However, the Commission clearly gave the term "transaction" a broader interpretation than that urged by the ICI. In fashioning its

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123. *Id.*

124. *Id.*

125. *In re* Steadman Security Corp., [1977-1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 81,243, at 88,339, 88,339-12 (June 29, 1977).

126. *Id.* at 88,339 n.49.

127. *Id.* at 88,339-12.

128. *Id.* at 88,339-13.

129. *Steadman*, [1974-75 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 80,038, at 84,831.

130. *See supra* note 26, at 88,339-12.

new standard, the Commission assumed that it was not necessary for the investment company and the affiliate to participate in the transaction through the same economic arrangement, even though this interpretation renders the standard enunciated in subsection (b) of section 17d-1[131] superfluous.

E. Section 17(d) and Incentive Compensation Plans

The Commission has long taken an expansive view of the application of section 17(d) to incentive compensation plans. The definition of "joint enterprise or other joint arrangement or profit sharing plan" in Rule 17d-1(c) expressly includes a stock option or stock purchase plan.[132]

Inclusion of stock option plans within the reach of section 17(d) is somewhat unnecessary since section 18(d) of the 1940 Act[133] provides that warrants or rights to subscribe issued by the investment company are unlawful unless they are issued *exclusively* to a class or classes of the company's security holders and expire within 120 days of issuance. Thus, it would appear that stock option plans involving directors who are not part of a shareholder class receiving warrants would be precluded by section 18(d).

Rule 17d-1 exempts certain stock option or stock purchase plans from its proscriptions. Subsection d(1) exempts any plan covering affiliates or employees of a company controlled by an investment company. However, in the release accompanying the exemption,[134] the staff makes it clear that the exemption is lost if the affiliate of the controlled company is also an affiliate of the investment company.[135] Subsection (d)(2) of the Rule also exempts any plan provided by an investment company or a controlled company if it qualifies under section 401 of the Internal Revenue Code[136] and if all contributions are deductible under section 404 of the Code.[137]

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131. *See* 17 C.F.R. § 270.17(d)-1(b) (1983), which sets forth the standard as "on a basis different from or less advantageous than that of other participants."

132. 17 C.F.R. § 270.17(d)-1(c) (1983).

133. 15 U.S.C. § 80(d) (1982).

134. SEC Inv. Co. Act Release No. 6154 [1969-1970 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 77,847, at 83,999 (Aug. 10, 1970).

135. *Id.* at 84,000. One literally applying the definition of affiliate contained in § 3(a)(3)(d) of the Act would conclude that an affiliate of a controlled company is by definition an affiliate of the investment company. He is an affiliate of an affiliate (controlled company) of the investment company. However, the exemption is lost only if the affiliation with the investment company is other than through the controlled company.

136. *See* 26 U.S.C. § 401 (1983).

137. *Id.* at § 404.

The Commission has proven more elusive in defining the scope of the term "profit sharing plan" as used in 17d-1(c).[138] In a release issued more than thirty years ago,[139] the Commission invited investment companies setting up bonus plans for officers and directors to seek *ad hoc* relief because it would be impossible in advance of application to determine if the bonus plan had profit sharing characteristics:

> The Commission has determined that all such plans with the exceptions provided in the amended rule should be the subject of an application under the rule. It would be the policy of the Commission to grant an application whenever it appears that the plan does not possess profit-sharing characteristics or where, even though possessing such characteristics, the plan is not substantially disadvantageous to the company involved.[140]

More recently, in *First Midwest Corp.*,[141] the staff offered clearer guidelines and stated that a plan possesses profit-sharing characteristics if the registered or controlled company is *obligated* to make payments as compensation or added compensation to any affiliate thereof; and the plan requires such payments to be made upon the basis of income, realized gain or loss on investments, or unrealized appreciation or depreciation of investments of such registered or controlled company.[142]

In *Narragansett Capital Corp.*,[143] the staff refused to issue a no-action letter in connection with a bonus arrangement which was to be contingent upon the payment of dividends by Narragansett over a threshold amount. In rejecting the company's arguments, the staff clearly indicated that removal of discretion from the board and the indirect relationship of payment to profits or income infused the plan with profit-sharing characteristics.[144]

Similarly, in *Variable Annuity Life Insurance Co. of America*,[145] the

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138. 17 C.F.R. § 270.17(d)-1(c) (1983).

139. SEC Inv. Co. Act Release No. 1598 [1951 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 48,399.10 (Mar. 20, 1951).

140. *Id.*

141. Available January 5, 1981. *First Midwest Corp.* was designated by the SEC as a significant letter.

142. *Id.*

143. [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 92,050, at 81,685 (Dec. 12, 1978).

144. Rule 17(d)-1 formerly contained an exemption for a bonus plan under which the payment and amount was wholly discretionary with the company. While this exemption has been deleted, *Narragansett* demonstrates that it is still a significant factor for the staff. *Id.* at 81,686.

145. 39 S.E.C. 680 (1960).

Commission rejected the company's request for an exemption pursuant to section 6(c) of the Investment Company Act[146] for a compensation plan that was tied into "free surplus." The staff reasoned that a reduction in the amount of free surplus would have the immediate effect of diminishing the equity of the company, and the Act was intended to protect that equity against the "self-interest and depredations of insiders."[147]

Therefore it is apparent that the staff would reject any plan that makes payment contingent either directly or indirectly upon income, and in which the board of directors does not retain any discretionary authority.

F. Expansive Applications of the Rule by the Division

By construing section 17(d) to encompass such a broad range of proscribed conduct, the staff has included a number of transactions which initially would appear to be outside the proscriptions of the Rule.

1. Service Contracts Between Affiliates and Investment Companies

While the definition of "joint enterprise or other joint arrangement or profit-sharing plan" contained in Rule 17d-1(c) expressly excludes the advisory contract,[148] the staff has long asserted the applicability of the Rule to transfer agency, custodian, distribution, or other service contracts with the advisor or other affiliates. In 1971, former Commissioner Owens noted the lack of arm's-length bargaining between a fund and its adviser in the negotiation of these service contracts and the potential for inside abuse.[149]

In 1974, the Commission proposed an amendment to Rule 17d-1(c) to remove existing uncertainties concerning the applicability of the Rule to service contracts.[150] Under the proposed amendment, service contracts would be excluded from the definition of joint enterprise if they were approved and renewed in the same way as advisory contracts, and a majority of disinterested directors determine that the service

146. 15 U.S.C. § 81a-1 to -52 (1940).

147. 39 S.E.C. at 692.

148. Advisory contracts are governed by § 15 of the Act. 15 U.S.C. § 80(a)-15 (1981).

149. Address by SEC Commissioner Owens, Mutual Fund Seminar, Dallas, Texas (May 6, 1971), SEC. REG. L. REP. (BNA) No. 101, at E-1, E-2 (May 12, 1971).

150. SEC Inv. Co. Act Release No. 8245 [1974 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 79,667 (Feb. 25, 1974).

contracts satisfied several specified criterion.[151] However, the amendment failed to be adopted and was withdrawn in 1979.[152] In the release announcing the withdrawal, the staff indicated its sensitivity to public criticism that the section and the Rule do not apply to these contracts at all: "A majority of the commentators questioned the Commission's authority to make rules regarding service contracts with affiliates pursuant to section 17(d) of the Act. The proposed requirement of shareholder approval of such contracts was also criticized as being inefficient and inappropriate."[153] However, the Commission stated that many companies had been granted no-action treatment in reliance upon the proposed rule and that the withdrawal of the amendment was not intended to indicate any change in the Commission's position.[154] In fact, the staff has acceded to no-action requests in two recent letters in which counsel indicated that the requirements of the proposed rule had been met.[155]

2. Joint Participation in Litigation

The staff has also asserted that section 17(d) applies to litigation conducted jointly by a fund and its affiliates. In *National Student Marketing Corp.*,[156] the staff declared that an application under section 17(d) should be filed prior to any sharing of legal fees in a lawsuit.[157] It was not persuaded by the Fund's argument that its sole purpose in joining the litigation was to benefit shareholders and that its legal expenses in joining the litigation would be far less than if it brought a separate action.[158] Evidently the staff was more concerned that the affiliates' legal expenses would also be reduced if the fund joined in the litigation.

Section 17(d) also applies to settlement negotiations. In *AB &*

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151. The criteria which must be satisfied are findings that the:
(a) contract serves the company's and shareholder's best interest;
(b) services performed are required by the company;
(c) affiliated person can provide services comparable to those offered by unaffiliated persons;
(d) fees are fair and reasonable in light of customary charges for comparable services.

Id.

152. SEC Inv. Co. Act Release No. 10822 [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,172, at 82,144 (Aug. 8, 1979).

153. *Id.*

154. *Id.* at 82,145, n.1.

155. IPI-Income and Price Index Fund, [1981 Transfer Binder], FED. SEC. L. REP. (CCH) ¶ 76,787 at 77,194.

156. [1973 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 79,524, at 83,435.

157. *Id.* at 83,437.

158. *Id.*

Co.,[159] the transfer agent was negligent in its record keeping and suit was instituted by various funds, their advisor and their underwriter. Eventually a settlement was agreed upon and counsel for the advisor sought a no-action position from the staff with respect to section 17(d), arguing that the settlement was not a "joint or joint and several participation" among the plaintiffs, but was a series of separate transactions between each of the plaintiffs and the defendants.[160] Counsel further contended that since institution of the suit was not a joint transaction, a settlement could not be considered joint either, and that there was a complete absence of precedent supporting the applicability of section 17(d) to settlements.[161]

The staff disagreed, stating that section 17(d) applied because of the potential for abuse inherent in allocating settlement funds between the investment company and its affiliate.[162] They also asserted that there was precedent for this position.[163] Apparently unmindful of Judge Friendly's disdainful regard for uncontested administrative decisions, the staff cited an application for exemption which was filed even though two courts were required to approve the settlement transaction in the case.[164] The staff also rejected counsel's argument that settlement should

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159. [1974-1975 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 80,071, at 85,001 (Aug. 19, 1974).

160. *Id.* at 85,006.

161. *Id.*

162. The staff stated:

> In support of your opinion in this matter, you have indicated that you have been unable to find any precedent for the application of Section 17(d) and Rule 17d-1 thereunder to settlement agreements generally. The lack of precedent in this area, however, does not be itself remove settlement agreements from the coverage of these provisions. As you are aware, the fundamental guidelines for interpreting the federal securities laws is that they should be broadly construed to effectuate their remedial purposes. In this regard, it is our view that a settlement of litigation contemplating a monetary aware constitutes a "transaction" or "arrangement" within the meaning of Section 17(d) and Rule 17d-1, and, further, that a settlement of litigation involving the allocation of funds between registered investment Companies and their affiliates could conceivably give rise to the kinds of abuses which those provisions are intended to eliminate.

Id. at 85,007.

163. Fifth Avenue Coach Lines, Investment Company Act Release No. 7025 (Feb. 29, 1972).

164. The staff stated:

> Moreover, we are unaware of any precedent suggesting that Section 17(d) is *not* applicable to settlement agreements involving registered investment companies and their affiliates and principal underwriters. In fact, we think that the recent application for exemption filed by Fifth Avenue Coach Lines and Gray Line Corporation furnishes ample support for concluding that an application should be filed when a registered investment company

be exempt because commencement of a suit is exempt, observing that in some instances even the institution of suits by funds and affiliates could easily come within the reach of its jurisdiction under section 17.[165]

VI. EFFECT GIVEN TO EVIDENCE INDICATING THAT FUND HAS BEEN ADVANTAGED BY TRANSACTION

A recurring issue in section 17(d) cases is the weight given by the court to evidence that the fund has been treated fairly or has been clearly advantaged by the transaction. The staff and the courts have apparently agreed on the applicability of section 17(d) without regard to the apparent fairness or advantage of the transaction. For example, in *Wellman v. Dickinson*,[166] the court found a violation of the rule to exist when the funds and the affiliate failed to seek approval of the transaction, even though the funds tendered their shares for a substantial premium and the affiliate reimbursed the funds for a portion of the compensation it received from handling the acquisition for the offeror. The court noted that the Act was designed "to proscribe the appearance of or conflicts of interest."[167] The Commission in *Imperial Financial Services, Inc.*[168] stated its position clearly: "The possibility that the investment company was not disadvantaged does not cure the unlawfulness of proceeding with the joint enterprises without obtaining the prior approval of this Commission as required by rule 17d-1."[169]

The staff unequivocally reaffirmed this position in a recent no-

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> participates in a joint transaction with its affiliate, even though the transaction is effected in accordance with the terms of a settlement agreement which is subject to approval by a court (Investment Company Act Release No. 7025, February 29, 1972). In that proceeding, an application was filed even though two courts were required to approve the transactions and even though the transactions were effected pursuant to a Commission request. In our view, court approval of the present settlement agreement does not divest the Commission of jurisdiction over the transaction involved.

AB & Co. at 85,007.

165. *Id.* Apparently even court approval of a settlement will not remove a case from the jurisdiction of the Commission. In *Contran Corp.*, [1974-1975 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 80,105, counsel argued that a settlement involving a fund and its president did not require staff approval pursuant to § 17(b) or 23(c)(3) of the Act, because settlement would have to be approved by the court as fair and reasonable to all parties, including the fund and its security holders, pursuant to rule 23.1 of the *Federal Rules of Civil Procedure*. The staff disagreed, stating that the standards which the court applies under rule 23.1 and the standards which the staff applies under § 23(c) and rule 23c-1 are different. *Id.* at 85,095.

166. 475 F. Supp. 783 (S.D.N.Y. 1978).

167. *Id.* at 834.

168. 42 S.E.C. 717 (1965).

169. *Id.* at 727. *See supra* note 46.

action letter, but nevertheless granted the company's no-action request. In *Greene Cananea Copper Co*,[170] counsel argued that the section did not apply because the Fund was clearly advantaged when its parent proposed to guarantee a portion of a loan to the Fund's subsidiary. Counsel argued that this loan could not be obtained on such favorable terms absent the parent's guarantee.[171] The staff vehemently disagreed with counsel's argument but granted the requested relief.[172] The staff's inconsistent reply is a manifestation of the pattern its letters have often exhibited in instances where fairness or benefit to the fund has been convincingly demonstrated.[173] It is therefore apparent that advantage does not excuse a failure to seek an application pursuant to the Rule, but as *Greene Cananea* suggests, it may lead to no-action treatment.[174]

Evidence showing fairness or advantage to the fund, however, will not always obtain no-action treatment. In a number of letters the staff has been unmoved despite vehement protestations of fairness.[175]

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170. Greene Cananea Copper Co. (avail., Dec. 13, 1979).

171. *Id.*

172. *Id.*

173. Meridian Inv. & Dev. Corp., [1971-72 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 78,677, at 81,397; Continental Capitol Corp., [1972-73 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 79,122 at 82,424; Standard Shares, Inc., available Nov. 17, 1974.

174. A staff member at one time came close to admitting that the staff uses this pattern to preserve its position on the law, yet will grant the request when no overreaching is present. Milton Kroll, in the 1970 symposium with members of the staff on the applicability of § 17(d) to portfolio affiliates, posed the following question:

> Another question is whether § 17(d) applies to the situation where A co. makes a tender offer for the stock of B Co., and stock of B Co. is concurrently held by both an investment company and its portfolio affiliate. This situation is an illustration of the larger question as to whether mere parallel action by the investment company and its portfolio affiliate falls within § 17(d). Presumably, this is an open question, but, in my view, it does not appear that § 17(d) was meant to apply in such cases without more. However, again I'm inclined to believe that at least some on the commission staff would want to scrutinize any situation involving parallel action—such as the tender offer situation—in order to determine, for example, whether there is any overriding arrangement or agreement, however tacit or innocuous it is ultimately found to be.

Kroll, *supra* note 15, at 287. The response to Solomon Freedman of the Division is interesting:

> Milt, if you wrote in to us that question, you might get an answer like this: "While we do not necessarily agree that you are right on the law, we won't recommend any action." Or the answer might be, "While we disagree with your interpretation of the law, we won't recommend action."

Id.

175. *See, e.g.*, Midland Capitol Corp. and Thomas C. Connett, [1973-74 Transfer Binder], FED. SEC. L. REP. (CCH) ¶ 79,813, at 84,197; and Real Properties Securities Fund, [1972-73 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 79,273, at 82,793 (Dec. 18, 1972).

The only certain conclusion is that fairness or benefit is a significant factor in the staff's consideration of the no-action request. Moreover, the entire process illustrates some of the difficulties inherent in regulation by exemption. The Commission remains reluctant to establish a regulatory scheme that will clearly guide the industry, hence a case-by-case mode of operation is employed.[176]

VII. THE EFFECT OF A "TECHNICAL" VIOLATION

The Commission and the courts have often considered the technical nature of a violation in assessing sanctions. In *Steadman*,[177] the Commission offered some solace for the advisor when it held that his violations of section 17(a) were somewhat technical and therefore of little weight in assessing sanctions. Foreign unregistered funds advised by Steadman had been trading securities with registered American funds advised by Steadman. Since the spirit, if not the letter, of the Rule 17a-7 exemption applied, the Commission was unwilling to add to Steadman's troubles by assessing sanctions on the section 17(a) count.[178]

In *Bangor Punta Corp. v. Chris-Craft Industries, Inc.*,[179] the court relied in part upon the technical nature of the alleged violations in rejecting the plaintiff's claim for monetary damages. This case was unusual in that the plaintiff, a successful contestant in a corporate control fight, brought an action under section 17(a) claiming that the price it paid for stock of the target was greater than it would have been had the defendant not violated the section.[180] The plaintiff alleged that the defendant violated section 17(a) by purchasing the target company's stock from a fund at a time when both it and the fund owned five percent of the stock.[181] Since the defendant was an affiliate of an affiliate of the fund, plaintiff maintained that it should have sought prior approval of the transaction.[182] The court observed that section 17 applied to the transaction

> only upon a most abstrusely technical reading. It is not clear

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176. However, the exceptions themselves are not official precedents, and what H.L.A. Hart referred to as the penumbra of the rule remains fuzzy, even after 40 years of administrative interpretation. The hope of Dean Landis, et al in *The Administrative Process* (1938), that administrative agencies could win their spurs by refining the rules, based on their expertise, is hollow in this instance.

177. *In re* Steadman Sec. Corp., [1977-1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 81,243, at 88,339-13 (June 29, 1977).

178. *Id.* at 88,339-19.

179. 337 F. Supp. 1147 (S.D.N.Y. 1971).

180. *Id.* at 1149, 1152.

181. *Id.* at 1152.

182. *Id.*

> whether the mechanics of transfer and delivery and the "as of" dates for voting of [the target company's] stock at a forthcoming meeting were such as to truly vest in [defendant] voting powers for its 5% plus holding in [the target company] at the time. Even if it did have that power, the record before this Court is convincing that [defendant] did not then or thereafter, exercise any controlling influence in [the target company].[183]

Without applying an overly technical interpretation, the Court could discern no harm to the Fund or to its shareholders from the transactions because the Fund received $65 per share for its Piper stock at a time when the market price was in the low fifties.[184] The absence of injury to the fund combined with the technicality of the violation led the Court to conclude that the activities of the plaintiff were not within the scope of protection afforded by section 17(a).[185] It is not clear why neither the court nor the defendant invoked the exemption contained in Rule 17a-6[186] which removes purchases or sales between a fund and a downstream affiliate from the proscription of section 17(a).[187]

In *Mathers Fund, Inc. v. Colwell Co.*,[188] the Fund itself brought an action under section 17(a) seeking rescission of a sale of stock to Colwell Company, a downstream affiliate which had not sought prior approval from the SEC when it repurchased its own shares from the Fund. Since Colwell had repurchased the shares at a fair and reasonable price, suggestive of no misconduct on its part, the Seventh Circuit rejected the plaintiff's claim.[189] The court found there was a technical violation of the letter of section 17(a)(2), but not of its spirit, and noted that the policies of the Act would not be furthered if rescission of the sale was granted.[190]

Atypically, the Fund itself was seeking rescission in this case, a fact which generated some judicial cynicism as to its motives in invoking section 17. The court noted that the Act was intended to protect against self-dealing, not to encourage:

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183. *Id.* at 1153.
184. *Id.* at 1154.
185. *Id.*
186. 17 C.F.R. § 270.17(a)-6 (1983).
187. *Id.*
188. 564 F.2d 780 (7th Cir. 1977).
189. *Id.* at 784.
190. *Id.*

> speculation by enabling investment companies to accumulate more than 5 percent of a corporation's stock, to sell that stock to the corporation (which may be unaware that it is a statutory "affiliate" or that the Act is applicable to the transaction), and then to sue for rescission where, as here, the price has increased.[191]

Thus, it is apparent that what was intended as a shield against overreaching had instead been used by the fund as a sword. This decision, therefore, like *Bangor Punta*,[192] may be of limited relevance in the typical section 17 factual situation.

Talley[193] is also instructive as to the mental state necessary to turn a technical violation into a remediable one. In that case, the SEC sought withdrawal of the votes cast at the General Time Corporation annual meeting, but the Court considered such a result inequitable because of the lack of precedent construing section 17(d) in a takeover context as well as the ambiguous language contained in the Rule. As a result, the court found only an "innocent violation" of section 17(d).[194] In light of the *Talley* precedent,[195] however, one can no longer successfully plead ignorance of the scope of the section in a takeover context.

In a few cases, the fact that the affiliation was involuntarily created through purchases on the open market has made a difference. For example, in *M. Kimelman & Co*,[196] a limited partnership sought a finder's fee from Talley Industries in connection with Talley's takeover of General Time Corporation. M. Kimelman & Co. was a statutory affiliate of the Fund because during the relevant period a limited partner of the company was affiliated with Talley Industries, a company in which the American Investors Fund held an eight percent interest.[197] Judge Soffer held that Kimelman was entitled to the finder's fee, noting that shareholders of the Fund no longer had an interest since the Fund had long since divested itself of Talley shares. He added:

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191. *Id.*

192. 337 F. Supp. 1147 (S.D.N.Y. 1971).

193. SEC v. General Time Corp., 407 F.2d 65 (2d Cir. 1978). *See supra* notes 23-27.

194. *Id.* at 70.

195. *See supra* notes 23-27 and accompanying text.

196. [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 81,516, at 80,087 (1978).

197. On appeal, the Commission held that there was no affiliation between the company and the fund through Oscar Kimelman, a limited partner of the company, because a limited partner under New York law cannot interfere in the conduct or control of the business. *In re* M. Kimelman & Co., [1970 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 81,994 (Feb. 2, 1979).

> Nor is there that kind of affiliation between the parties which requires that the Commission prevent the payment of the fee. As a matter of fact, if applicant is in any way an affiliated person (through Oscar Kimelman) of an affiliated person (Industries), it is wholly involuntary on the part of either company.[198]

The judge relied upon *American Bakeries Co.*,[199] in which the Commission granted a retroactive exemption to the American Bakeries Company pursuant to section 6(c) of the Act.[200] The affiliation of the company to the Fund was completely involuntary because the Fund had acquired its holdings in the open market.[201]

VIII. THE DOWNSTREAM EXEMPTIONS

A. *Subparagraph (d)(5)*

In 1974, the downstream affiliate exemption was added to Rule 17d.[202] Although the language of this exemption is somewhat confusing, the scope of subparagraph (d)(5) is more easily understood if one keeps in mind the problem it was designed to address: the unintended breadth of the Rule's coverage of transactions involving downstream affiliates. The exemption was formulated to exclude certain joint enterprises from the coverage of the rule when no upstream affiliate, potentially in a position to influence the terms of the enterprise, engages in the joint enterprise. It is thus meant to clarify the extent to which downstream affiliates must adhere to section 17(d). In the *Talley* case, Judge Friendly held that both the section and the Rule applied even though Talley Industries was a downstream affiliate of the Fund; i.e., the Fund owned nine percent of Talley's shares and not vice versa.[203] Conceding that the argument for application of the section was much stronger in a situation where upstream affiliates were involved, he nevertheless saw the possibility for abuse. Thus, subparagraph (d)(5)(i) was designed to take into account and mitigate the consequences of the *Talley* decision.

Subparagraph (d)(5) exempts any joint enterprise or other joint arrangement or profit-sharing plan in which both an investment com-

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198. [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 81,516, at 80,095. 199. 103 Sec. Docket 88 (Sept. 13, 1977).
200. 15 U.S.C. 80A, § 6(c) (1982).
201. 103 Sec. Docket at 90 n.16.
202. 17 C.F.R. § 270.17d-1(d)(5) (1983).
203. *General Time Corp.*, 407 F.2d at 66-67.

pany (or its controlled company) and an affiliated person of that investment company (or an affiliated person of that person) participate. The exemption will apply provided that no person described in subsections (a) through (e) of paragraph (d)(5)(i) of the Rule is a participant in the joint enterprise *through* a direct or indirect financial interest in any person, except the investment company, participating in the joint enterprise.[204] Pursuant to (d)(5)(ii) the exemption is lost if the investment company commits more than five percent of its assets to the joint enterprise. The persons described in subsections (a) through (e) are those individuals who, by virtue of their relationship to the investment company, could potentially influence the terms of the joint enterprise to the disadvantage of the investment company.[205] It should be noted that the persons designated in subsections (a) through (e) need not participate directly in the joint enterprise for their activity to be nonexempt; they need only have a direct or indirect financial interest in a joint enterprise participant other than the investment company.[206]

Consistent with this broad approach, the rule defines the term "financial interest" by negative implication, as it lists a series of interests that would *not* be considered a financial interest.[207] One must speculate whether the correct inference to be drawn from this is that virtually every other interest would come within the definition. There is evidence that the staff would be comfortable with such a construction. For example, in the release accompanying the proposal of the (d)(6) exemption, the staff stated that an arrangement by a (d)(5)(i) person for future employment with the affiliated company would constitute a financial interest within the definition.[208]

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204. 17 C.F.R. § 270.17(d)(5)(i) (1983).

205. These individuals are:

(a) An officer, director, employee, investment adviser, or underwriter for the registered investment Company,

(b) A person directly or indirectly controlling the registered investment company,

(c) A person hold more than a 5% interest in the investment company,

(d) A person under common control with the registered investment company, and

(e) An affiliated person of any of the foregoing.

17 C.F.R. § 270.17d-1(d)(5)(1)(a)-(e) (1983). Investment Company Act Release No. 10699 (May 16, 1979).

206. 17 C.F.R. § 270.17(d)(5)(1)(a)-(e) (1983).

207. 17 C.F.R. § 270.17d(5)(e)(iii) (1983).

208. SEC Inv. Co. Act Release No. 10699, [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,077 (May 16, 1979): The release describes the "financial interest" necessary when a person described in (d)(5)(i) is involved as : "a person who, by virtue of their relation to the investment company, potentially could influence the terms of the transaction to the investment company's disadvantage."

The lack of a clear definition of this term creates certain problems. If an investment company wishes to transact business with a downstream affiliate that is a public company, is the exemption lost because a director of the investment company has a financial interest in the form of ownership of a few shares in the affiliate? This was the conclusion reached by counsel in *Finance Company of Pennsylvania*.[209] In the release, it was conceded that the rule 17a-6 exemption, which is the parallel exemption to rule 17(a), was unavailable because persons owning more than five percent of the investment company's securities also owned common stock of the affiliate involved in the transaction. Counsel did not indicate the extent of ownership by those persons in the affiliate, but admitted that it was an indirect financial interest rendering the exemption unavailable.[210]

The examples offered by the staff in the release proposing the adoption of subparagraph 17d-1(d)(5)[211] are revealing, particularly the third example which provides:

> Where two registered investment companies each own 5% or more of the common stock of the same portfolio company, each is an affiliated person of an affiliated person of the other. Under [proposed] new subparagraph (5), it would not be necessary to file an application under Rule 17d-1 where either or both of the investment companies desire to increase or decrease their holdings of such security or to exchange securities with the portfolio company, provided that the persons specified in [proposed] subparagraph (5)(i) do not [participate or] have a financial interest in the joint transaction.

This illustrates the broad reach of the SEC staff. Indeed, when it suggests that the new rule was needed to sanctify a transaction "where *either* or *both* of the investment companies desires to increase or decrease their holdings,"[212] it is unclear how such a transaction comes under the prohibition of section 17d in the first place. Judge Friendly in

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209. SEC Inv. Co. Act Release No. 11048, 45 Fed. Reg. 11,641 (Feb. 21, 1980).

210. However, in a similar instance, the Madison Fund did not concede this issue. Instead, it argued that ownership of a miniscule number of shares in the other party to a transaction by two directors of the fund did not render the rule 17a-6 exemption unavailable.

211. [1974-1975 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 79,982, at 84,526 (Oct. 15, 1974).

212. *Id.* at 84,529.

Talley[213] required at least "some element of combination"[214] to be present before a joint enterprise or transaction could be found. According to the above-cited example, an investment company unilaterally increasing or decreasing its holdings in a portfolio affiliate could be unwittingly involved in a joint enterprise with another investment company merely by virtue of this second investment company's affiliation with the same portfolio company.

Apparently practitioners have had little trouble interpreting the exemption for there have been relatively few no-action requests involving subparagraph (d)(5). However, some interesting problems remain undefined. In particular, the downstream exemption in 17d-1(d)(5) is paralleled by a similar exemption from the proscriptions of section 17(a) with one important distinction. The 17(d) downstream exemption is limited to transactions in which less than five percent of the assets of the fund are committed while the 17(a) downstream exemption has no such limit. Consequently, it becomes important to determine whether a given transaction is a purchase and sale subject to 17(a) or a joint arrangement subject to 17(d).

B. Subparagraph (d)(6)

Subparagraph (d)(6)[215] contains another significant exemption which is applicable when securities and/or cash are received by an investment fund and its affiliates pursuant to a portfolio company reorganization, and the (d)(5) exemption is unavailable because upstream affiliates also own stock in the reorganizing company. Certain safeguards are provided. First, the exemption applies solely to transactions in which the upstream insider's financial interest in the company undergoing reorganization is limited exclusively to ownership of the same class or classes of securities as those owned by the investment company.[216] Second, the exemption requires that the investment company and the persons described in subparagraph (d)(5)(i) receive securities of the same class and/or cash under identical terms, and that pro rata distributions be made according to each participant's prior holdings.[217] Third, the exemption does not apply if an upstream affiliate has a financial interest in any person other than the investment company which is participating in the reorganization.[218]

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213. *Talley*, 399 F.2d at 396, *cert. denied*, 393 U.S. 1072 (1969).
214. *Id.* at 403.
215. 17 C.F.R. § 270.17d-1(d)(6) (1983).
216. 17 C.F.R. § 270.17d-1(d)(6)(i) (1983).
217. 17 C.F.R. § 270.17(d)-1(d)(6)(ii) (1983).
218. 17 C.F.R. § 270.17(d)-1(d)(6)(iii) (1983).

It is interesting that in drafting this exemption, the staff assumed that the mere simultaneous receipt of securities or cash by an investment company and its affiliates is a joint transaction or participation which, absent an exemption, would require an application of the section. Once again, the staff applies an even broader interpretation of the term "joint or joint and several participation" than that offered by Judge Friendly in *Talley*.

IX. AFFILIATION THROUGH CONTROL

In applying section 17, an important question is whether an advisor or fund manager controls the fund. If either does, then he or she is deemed to be an insider for the purposes of the (d)(5) exemption.[219] Other investment companies he or she controls would likewise be considered affiliates[220] as well as insiders for purposes of the (d)(5) exemption.[221]

The Commission has been somewhat inconsistent in its approach to the question of whether the advisor controls the fund. In *In re Steadman Security Corp.*[222] the Commission unequivocally stated that "[o]nly in the very rare case where the advisor's role is simply that of advising other parties who may or may not elect to be guided by his advice . . . can the adviser realistically be deemed not in control."[223] This position was cited approvingly in the release accompanying the proposed subparagraph (d)(8) exemption to Rule 17d-1,[224] which allowed an investment advisor to bear expenses associated with a merger of investment companies.[225] However, in the release accompanying the adoption of the exemption, the Commission took a less concrete position, noting that "[t]he rule does not represent a Commission finding

219. See 17 C.F.R. § 270.17d-1(d)(5)(i)(b) (1983) which defines an insider as "[a] person directly or indirectly controlling the registered investment company." *Id.*

220. 15 U.S.C. § 90a-2(2) (1981).

221. 17 C.F.R. § 270.17d-1(d)(5)(i)(d) (1983).

222. [1977-1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 81,243 (June 29, 1977). Steadman offered three arguments to support its contention that there was not a control relationship as defined in § 2(a)(9). These were: the fact that ownership and therefore control of the funds stock was by certain European banks and not Steadman; that Steadman controlled less than 25% of the fund's securities and thus the § 2(a)(9) presumption against control was in effect; and finally, that any controlling influence the advisor had was solely due to this official position with such company. *Id.* at 84,815.

223. *Id.* at 88,339.

224. [1979-1980 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,314, at 82,356, 82,357 n.5 (Oct. 3, 1979). This exemption allows an investment advisor to bear expenses associated with a merger of investment companies. *Id.*

225. 17 C.F.R. § 270.17(d)-1(d)(8) (1983).

that investment companies having common officers, directors or investment advisers are always affiliated persons or affiliated persons of an affiliated person. They may or may not be, depending on the facts."[226]

Steadman suggests that one critical fact indicating control of the fund is the degree of discretion in the advisee to accept or reject the advisor's recommendations. In any event, the Commission's observation that investment companies with a common advisor will not always be affiliated is a softening of its position in *Steadman*. It is, however, entirely consistent with the much earlier position taken by the drafters of the proposed rule revisions.[227]

A related issue is whether two funds that share identical officers and directors are under common control and thus affiliated. In *Transwestern Mutual Fund & Industry Fund of America*[228] counsel for two funds that had the same officers and board contended they were not affiliated. Counsel argued that an officer's or director's controlling influence over a fund results solely from his official position with the fund and is therefore expressly excluded from the definition of control contained in section 2(a)(9).[229] The staff conceded that the exclusionary language of section 2(a)(9) applied, but disagreed with counsel that control was not shown on these facts.[230] The staff declared that identical officers and directors indicated that the power to determine the composition of the board lay in the same person and therefore the two companies were under the common control of this person. The staff did not identify the person alleged to be exerting that controlling influence.[231]

Frequently, whether control is present will depend upon the in-

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226. SEC Inv. Co. Act Release No. 11053, [1979-1980 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,452, at 82,906 n.2 (Feb. 19, 1980). This remark by the Commission shows that there was a need to retain some control of the situation and not to promulgate a per se rule. *Id.*

227. *See* [1966-1967 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 77,477 (Mar. 11, 1967). While never promulgated, this proposal has never been officially withdrawn. The proposal contemplated a change in the definition of the term "affiliated person" to exclude investment companies affiliated merely by virtue of a common investment advisor.

228. [1979-1980 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,441, at 82,861 (Oct. 19, 1979).

229. 15 U.S.C.A. § 80a-2(9) (1981). "Control" is defined as "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." *Id.*

230. Transwestern Mut. Fund & Indem. Fund of Am. [1979-1980 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,441, at 82,86 (Oct. 19, 1979).

231. *Id.*

itial question of whether a given economic arrangement can be deemed the equivalent of a "voting security." Section 2(a)(42) of the Act defines a voting security as "any security presently entitling the owner or holder thereof to vote for the election of directors of a company."[232] Although this appears to be a fairly straightforward definition, one should be wary of too literal an interpretation. The staff adopts a more expansive view, and includes non voting influences upon the composition of a board of directors within the definition.[233] The staff has also taken the position that interests in limited partnerships and certain funds which give the holder the power to exercise control through economic power are "functionally equivalent to voting securities."[234] Evidently, the characterization of a security as a voting security depends more on the facts of a particular case than on the type of security involved.

A pertinent example is the generally prevailing view of the staff that convertible debentures are not voting securities.[235] However, in *Midland Capital Corp.* and *Thomas E. Connett*,[236] convertible debentures in default were deemed the equivalent of voting securities, conferring control upon their holder even though for economic reasons the holder chose not to exercise its conversion rights under the debenture agreement. In its inquiry letter, counsel argued that the fund did not control the defaulted company because it had no inclination to exercise its conversion rights since it was in a more favorable position as a creditor than as an equity holder in the company.[237] This argument, however, did not persuade the staff in *Midland*. In that case, the possibility that conversion could result in actual control was sufficient to find direct or indirect control by the holder over the company.[238]

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232. 15 U.S.C. § 270.2(a)(42) (1981).

233. National Liquid Reserves, Inc., SEC No. Action Letter [1980 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 76,346 (Feb. 28, 1980).

234. SEC No-Action Letter, FMR Inv. Management Serv., Inc. (available Nov. 28, 1979); SEC No-Action Letter, Devenshire Capital Corp. (available Feb. 15, 1975).

235. Property Capital Trust (avail., Oct. 19, 1979).

236. SEC Letter ICA-1940 Act April 10, 1974/47,162.155, 48,402.165 (SEC 1974); N-A Ltr. 73-74 Dec. 79,813/[1973-1974 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 79,813 (1974).

237. This argument echoes that offered by Milton Kroll in the 1970 symposium on § 17 and portfolio affiliates with members of the staff. There he argued that:

> convertible debentures which are presently convertible by their terms and which are held by a balanced fund, should not be considered presently convertible if their conversion would materially and adversely affect the ratio of debt securities to equity securities in light of the fund's investment objectives and policies and the economic conditions existing or anticipated at the time.

Kroll, *supra* note 15.

238. *See supra* note 229.

The same reasoning could apply to preferred stock that is presently convertible. The right to convert and not the actual conversion is the critical factor in determining the existence of a control relationship. An interesting question would arise if a corporation amended its preferred stock agreement to postpone conversion to avoid problems with section 17. An extended discussion of whether or not a particular economic arrangement constitutes a voting security is beyond the scope of this discussion. However, it should be noted that in applying the "de facto" standard, the staff will turn its attention to certain economic arrangements which do not initially appear to come within the scope of section 2(a)(42). For example, in *Property Capital Trust*,[239] a promissory note set up certain ongoing dealings between the issuer and the holder of the note. Because counsel felt that this arrangement could be deemed the equivalent of a voting security, it sought and received a no-action position. Similarly, in *Narragansett Capital Corp.*,[240] counsel obtained confirmation of its view that neither a promissory note granting Narragansett substantial economic power over the affairs of the debtor, nor nonvoting stock which could entitle Narragansett to designate directors of the company were the equivalent of a voting security.

X. IMPLIED PRIVATE RIGHT OF ACTION UNDER SECTION 17(d)

As of this date, no court has squarely addressed the issue of whether an implied private right of action for investment company shareholders exists under section 17(d). Several lower court decisions, however, have assumed or asserted the existence of such a right under the Act generally, or under other isolated provisions.[241] The importance of these decisions for section 17(d) analysis is problematic, particularly in view of recent Supreme Court pronouncements.

In the authors' opinion, it is unlikely that the courts will find private rights of action to exist based solely on a violation of section 17. The issue will likely depend on whether the Supreme Court's holding in *Merrill Lynch v. Curran*[242] is interpreted as acknowledging

239. Property Capital Trust (avail., Oct. 19, 1979).

240. (SEC 1978) N-A Ltr: 1979 Dec. § 81,952, ¶ 82,050.

241. *See, e.g.*, 15 U.S.C. §§ 270.10(a) & (d), 15, 15(c), 17(a), 35(d), 36, 37, & 44 (1981); *see also* Brown v. Bullock, 294 F.2d 415 (2d Cir. 1961); Taussig v. Wellington Fund, Inc., 313 F.2d 472, 476 (3d Cir. 1963), *cert. denied*, 374 U.S. 806 (1963); Levitt v. Johnson, 334 F.2d 815 (1st Cir. 1964), *cert. denied*, 379 U.S. 961 (1965), *cert. denied*, 394 U.S. 928 (1968); Tannenbaum v. Zeller, 552 F.2d 402 (2d Cir. 1977); Moses v. Burgin, 445 F.2d 369 (1st Cir. 1971).

242. 456 U.S. 353 (1982).

implied remedies under the Act. This issue is complicated by the Supreme Court's holdings in *Touche Ross Co. v. Redington*[243] and *Transamerica Mortgage Advisors, Inc. v. Lewis*,[244] which are popularly viewed as severely limiting implied rights of action under the securities laws.

Curran involved the putative existence of an implied private right of action under the Commodity Exchange Act (CEA).[245] The purpose of this Act had been to create, *inter alia*, a new regulatory commission authorized to grant reparations to any person complaining of CEA violations. The five-man majority opinion reemphasized the importance of focusing inquiry upon legislative intent, an exegesis made most difficult by continued congressional unwillingness to express its desires relative to private rights of action. When Congress undertakes extensive amendments to an act after a number of federal courts have found, with some degree of unanimity, an implied private right of action under the act, the question becomes whether Congress, in revising and amending the act, intended to *preserve* the preexisting remedy.[246] The fact that comprehensive examination and significant amendment of the CEA left intact the statutory provisions under which the federal courts had implied the right of action, constituted persuasive evidence that Congress intended to preserve that remedy. Therefore the Court found a private right of action to exist under the CEA.[247]

If *Curran* is viewed as a substantial retreat from *Redington* and *Lewis*, then a new means of discerning congressional intent has apparently been delineated. The courts will read congressional silence as approval, and that tacit approval will be treated as an expression of congressional intent in construing amendatory legislation.

In all probability, however, *Curran* will be more or less limited to its facts. When the case was decided, it was well known that had the court ruled the other way, the CEA was scheduled to be amended by Congress to provide private rights of action. A series of abuses in commodities trading made it imperative that some federal agency act decisively. That imperative is not, however, equally compelling

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243. 442 U.S. 560 (1979). "There is no implied private cause of action for damages under § 17(a)." *Id.*

244. 444 U.S. 11 (1979). "It is not possible to infer the existence of an additional private cause of action." *Id.* at 12.

245. 7 U.S.C.A. § 1-4a, 5-6p, 7-7b, 8-9a, 10 note, 10a, 11, 12, 12-1 to 12-3 notes, 12a-12c, 13 to 13a-z, 13b, 13c, 14 note, 15, 16, 17, 18-24 (West 1980). The Act was extensively amended by the Commodity Futures Trading Commission Act of 1974, Pub. L. No. 93-463, 88 Stat. 1389 (codified as amended in scattered sections of 7 U.S.C.).

246. *Merrill Lynch*, 456 U.S. at 1839.

247. 50 U.S.L.W. 4457, 4464 (1982).

under the 1940 Act and particularly under section 17. Since 1940, the abuses have been relatively infrequent except in cases where excessive compensation was paid to advisors. In such cases, a private right of action is expressly contemplated by the Act.[248] With a paucity of instances of overreaching, particularly under section 17, it is highly unlikely that the *Redington/Lewis* reasoning will be ignored,[249] particularly in instances where there is no credible allegation of private profit, fraud, or concealment. Indeed, if the opposite were true, a difficult problem of construction would face the courts as they attempt to fill in the wide gaps in the language of the statute and rules. As a result, the Commission could be flooded with a raft of applications for exemptive orders.

XI. UNRESOLVED ISSUES

A. *Contracts Detailing Joint Transactions Entered Into by Precontract Nonaffiliates*

It is unclear from section 17 what the result should be when sections 17(a) and 17(d) arguably overlap.[250] For example, an investment company and an industrial corporation enter into a purchase agreement that both creates an affiliation between them and sets up mutual contingent obligations unrelated to the purchase.

Rule 17a-4 exempts from section 17(a) transactions pursuant to a contract entered into when the parties were unaffiliated and had been unaffiliated for the preceding six months.[251] This would seem to protect the parties from SEC interference with future purchases, sales, and loans made pursuant to this contract, but not from other joint transactions that might be covered by section 17(d). The SEC has taken the position, however, that the 17a-4 exemption will not apply if the contractual arrangements gives to either party any element of choice in fulfilling his other contractual obligations.[252] An element of choice apparently presents the opportunity for the affiliate to exercise its presumed influence upon the investment company, to

248. 15 U.S.C. § 80A-36 (1981). "This section making it a crime to convert assets of any registered investment co. gives implied private right of action." Brown v. Bullock, 194 F. Supp. 207 (D.C.N.Y. 1961), *aff'd*, 294 F.2d 415 (2d Cir. 1961).

249. Although the Second Circuit in SEC v. General Time Corp., 407 F.2d 65 (2d Cir. 1968), gave some contrary indications, noting, "We were the first court of appeals to uphold private actions to enforce duties created by the Investment Company Act." *Id.* at 70.

250. 15 U.S.C. § 80a-1 to -52 (1940). *See supra* notes 7-23 and accompanying text.

251. 17 C.F.R. § 270.17a-4 (1983).

252. Kroll, *supra* note 15, at 274 n.21.

its detriment,. as each party carries out the terms of the contract. No analogous rule exists under section 17(d), exempting joint transactions from its coverage if those transactions were agreed upon by nonaffiliates who became affiliated solely by reason of the purchase agreement that also sets up the joint transaction. Joint transactions are evidently viewed by the SEC as even more dangerous to investment companies than purchases, sales and loans. This viewpoint is supported by the fact that the Rule 17d-1(d)(5) exemption for downstream transactions is defeated if the investment company commits more than five percent of its assets to the enterprise.[253] No such limitation inheres in the analogous Rule 17a-6 exemption.

The only relevant authority dealing with the application of section 17(d) to joint transactions structured pursuant to a purchase agreement creating an affiliation between previously unaffiliated entities is the SEC no-action letter in *New America Fund, Inc.*[254] The implications of that ruling for future transactions of this sort are not entirely clear since the letter was issued without explanation. The staff appeared to have agreed with the Fund's principal argument that the prohibitions against self-dealing contained in section 17 are inapplicable to the Fund's acquisition of the outstanding stock since the terms of the acquisition were the result of "arm's-length" dealings.[255] Conceding that affiliated relationships will arise after the Fund's acquisition is completed, the staff letter concluded that section 17 was generally not intended to apply to the performance, by affiliated persons, of obligations created by contracts negotiated and entered into at a time when such persons were not affiliated.[256]

The SEC's argument in *Sterling Precision*,[257] which asserts that the 17a-4 exemption does not apply if either party retains any "element of choice" must, however, be kept in mind. An element of choice provides an opportunity for self-aggrandizing by affiliates in the process of executing the contractual agreement, even though it was reached at arm's length. In fact, the SEC's position until *Sterling Precision* was that the redemption of securities and call of stock pursuant to an original purchase and sale agreement was a repurchase subject to section 17(a), despite the minimal element of choice.[258]

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253. 17 C.F.R. § 270-17d-1(d)(5) (1983).
254. SEC No-Action Letter ICA 1940 Act (June 8, 1972).
255. *Id.*
256. *Id.*
257. SEC v. Sterling Precision Corp., 276 F. Supp. 772 (S.D.N.Y. 1967).
258. *Id.* at 773.

In this connection, it could be argued that the absence of an analog to the section 17a-4 exemption in the rules under section 17(d) means that executory contract obligations between hitherto nonaffiliates cannot be carried out absent an exemption. However, this does not appear to be the staff's position. The argument is based, as always, on the breadth of the term "joint enterprise." Assume Fund A purchases sufficient stock in Corporation B to create an affiliation and the purchase agreement contains post-closing obligations, for example, to assign for cash a lease to A for minimal space in B's premises. The post-closing obligation to lease space does not easily fall within the scope of the word "purchase" and, therefore, 17a-4 is unavailable. However, the entire contract can be, and is expressly, viewed as a joint enterprise initially entered into by nonaffiliates. The conspicuous omission of a Rule 17a-4 analog to 17(d) should not mean that nonaffiliates need a waiver to carry out joint transactions entered into coincident to the affiliation.

B. Deregistration

A registered investment company that wishes to cease functioning as an investment company and change its mode of operation to that of an operating company may confront some interesting problems under the Investment Company Act. Because the switch to an operating company will frequently be effectuated by increasing existing ownership interests in one or more portfolio companies, the investment company's preparations for deregistration will often involve multiple transactions with affiliates which may violate section 17(d) as well as other sections of the Act.[259] In order to deregister and thereby escape continued SEC scrutiny, the investment company must obtain a section 8(f)[260] order from the SEC. However, such an order will not issue prospectively; that is, the investment company must already have ceased to be an investment company in accordance with other provisions of the Act before it will be entitled to a section 8(f) order of deregistration. Therefore, section 8(f) will not provide any shield against commission sanctions for section 17 violations committed in the effort to cease operating in the investment company mode.[261]

One possible means of protecting its efforts to transform itself is for the investment company to seek a blanket exemption from the

259. 15 U.S.C. § 90a-17(d) (1982).
260. 15 U.S.C. § 90a-8(f) (1981).
261. *Id.*

provisions of the Act under section 6(c).[262] In the usual case, however, this is likely to be very difficult, since an investment company desirous of a section 6(c) exemption is obligated to show that Congress did not foresee a situation of the type it presents, and also that the investor protection afforded by the Act is no longer required.[263] The difficulty of meeting this burden coupled with the length of the process involved in section 6(c) argues cogently against choosing this route.

There is a catch-22 aspect to the deregistration process. The shareholders have endorsed deregistration because it is in their best interest economically. However, for their protection the Act, via certain provisions including section 17, can set up certain roadblocks to achieving deregistration in a manner economically advantageous to its shareholders. Perhaps this is why it has been suggested that section 17 be applied less vigorously to such transactions.[264] While clearly the operation of section 17 is not suspended during the period of deregistration, since the shareholders of the investment company presumably still require protection, it seems desirable that transactions necessarily incident to deregistration which do not involve any real possibility of insider abuse should not be subjected to the scrutiny that an exemptive order under section 6(c) entails. Such a rationale probably underlies the staff's decision to issue a no-action letter in *Meridian Investing & Development Corp.*[265] The staff's response emphasized Meridian's impending deregistration without prompting by counsel, who made no reference to deregistration in its letter. In fact, the staff expressly disagreed with counsel's argument that section 17(d) was inapplicable, but stated that since Meridian would soon be soliciting shareholder approval of a deregistration plan, no action would be recommended.[266] The possibility of a veritable flood of exemption applications required for all the various transactions occurring with the transition from investment to operating company may also have influenced the staff's response.

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262. 15 U.S.C. § 80a-6(c) (1981).

> The commission, by rules and regulations upon its own motion, or by order upon application, may conditionally or unconditionally exempt any person, security, or transactions, or any class or classes of persons, securities or transactions, from any provision . . . to the extent . . . appropriate in the public interest and consistent with protection of investors. . . .

Id.

263. *Id.*

264. *Id.*

265. [1971-1972 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 78,657 (Sept. 31, 1971).

266. *Id.* at 81,397.

The exact degree of relaxation of scrutiny of the course of such conduct intended to culminate in deregistration is unclear. In *South Bay Corp,*[267] the staff refused to take a no-action position under section 17(d) despite South Bay's intention to seek deregistration. Undoubtedly, this refusal was based in part on the possibilities for self-dealing created by the dual affiliation of the controlling person of the Fund who was receiving consultant fees from the other party to the transaction However, the SEC may be similarly reluctant to convey the impression that investment companies in the process of deregistration have carte blanche in their transactions with affiliates.[268]

XII. CONCLUSION

There has been little involvement by the courts in the forty year evolution of section 17(d). Instead, the prominent mode of interpreting the section has been the nonprecedent setting no-action request in which the staff has often granted no action, yet expressly disagreed with the analysis provided by counsel in its inquiry letter. The application for an order pursuant to Rule 17d-1(b) is of little value, for the critical question of jurisdiction has usually been conceded and counsel is confined to arguing the fairness of the joint transaction.

Section 17, particularly section 17(d), has proven an apt example of the problems created by regulation by exemption. Clear lines delineating the scope of critical terms such as "joint enterprise" or "transaction" have never emerged. Today, after forty-two years of a regulatory pattern marked by many unnecessary twists and turns, Senator Taft's observation in the 1939 Senate hearings is unfortunately still true: "It is certainly pretty hard to understand what this section does prohibit and what it does not."[269]

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267. [1973-1974 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 79,819.

268. Even after deregistration has been consummated and a § 8(f) order obtained, SEC supervision may not be entirely evaded. Section 8(f) provides in part, "If necessary for the protection of investors an order under this subsection may be made upon appropriate conditions." 15 U.S.C. § 80a-8(f) (1981).

269. *See supra* note 14.