

PUBLIC

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RESPONSE OF THE OFFICE OF CHIEF COUNSEL
DIVISION OF INVESTMENT MANAGEMENT

Our Ref. No. 94-612-CC
The Royce Fund
File No. 811-3599

Your letter of September 27, 1994 requests assurance that we would not recommend enforcement action to the Commission under Section 12(d)(3) of the Investment Company Act of 1940 (the "Act") or Rule 12d3-1 thereunder in the event that registered investment companies advised by Quest Advisory Corp. ("Quest") or its affiliates (the "Funds") purchase securities issued by unregistered investment advisers to unregistered investment companies. You represent that all such purchases would be subject to the restrictions of Rule 12d3-1(b). You state that Quest is interested in purchasing for the Funds publicly traded securities of foreign issuers that are investment advisers to foreign investment companies.

Section 12(d)(3) of the Act generally prohibits a registered investment company and companies it controls from acquiring any security issued by a broker, a dealer, an underwriter, an investment adviser of an investment company, or a registered investment adviser. Rule 12d3-1 exempts from the prohibitions of Section 12(d)(3) certain acquisitions of securities of issuers engaged in "securities related activities." 1/ Subparagraph (d)(1) of the Rule defines "securities related activities" as a person's activities as a broker, a dealer, an underwriter, an investment adviser registered under the Investment Advisers Act of 1940, or as an investment adviser to a registered investment company (emphasis supplied). Thus, the exemption provided by the Rule would not appear by its terms to extend to acquisitions of securities issued by an unregistered investment adviser to an unregistered investment company.

You assert that the history of Rule 12d3-1 demonstrates that the Commission's failure to include a person's activities as an

1/ Rule 12d3-1(b) provides that notwithstanding Section 12(d)(3), an acquiring company may acquire any security issued by a person that, in its most recent fiscal year, derived more than 15% of its gross revenues from securities related activities, provided that: (1) immediately after the acquisition of any equity security, the acquiring company owns not more than 5% of the outstanding securities of that class of the issuer's equity securities; (2) immediately after the acquisition of any debt security, the acquiring company owns not more than 10% of the outstanding principal amount of the issuer's debt securities; and (3) immediately after any such acquisition, the acquiring company has invested not more than 5% of the value of its total assets in the securities of the issuer.

unregistered investment adviser to an unregistered investment company within the definition of "securities related activities" was inadvertent. In 1984, the Commission amended Rule 12d-1 and redesignated it as Rule 12d3-1. Prior to this amendment, securities related businesses were defined to include, in the case of investment advisers, "an investment adviser of an investment company, or an investment adviser registered under" the Act. 2/ When the Commission adopted Rule 12d3-1, the definition of securities related activities was limited, with respect to investment advisers, to registered advisers or investment advisers to "registered" investment companies. The release adopting Rule 12d3-1 did not explain why the word "registered" was added to the definition. 3/

In 1989, the Commission proposed amendments to Rule 12d3-1 that, among other things, would have amended the definition of "securities related activities" to include a person's activities as an investment adviser to an unregistered investment company. 4/ Footnote 2 of the 1989 Release stated that absent this change to the definition,

acquiring companies cannot rely on [R]ule 12d3-1 to acquire interests in a company that serves as an [unregistered] investment adviser to an investment company, foreign or domestic, that is not registered with the Commission.

For reasons unrelated to the change discussed in footnote 2 of the 1989 Release, the proposed amendments were never adopted. 5/

In 1993, the Commission proposed and adopted amendments to Rule 12d3-1, but did not amend the definition of "securities related activities." Neither the proposing nor the adopting release discussed the concerns raised in footnote 2 of the 1989 Release. 6/

2/ See Investment Company Act Release No. 4044 (Sept. 4, 1964) (adopting Rule 12d-1).

3/ See Investment Company Act Release No. 14036 (July 13, 1984).

4/ See Investment Company Act Release No. 17096 (Aug. 11, 1989) (the "1989 Release").

5/ See Investment Company Act Release No. 19204 (Jan. 8, 1993).

6/ See Investment Company Act Release Nos. 19204 (Jan. 8, 1993) and 19716 (Sept. 23, 1993).

We would not recommend that the Commission take enforcement action under Section 12(d)(3) of the Act or Rule 12d3-1 thereunder if the Funds acquire securities issued by unregistered investment advisers to unregistered investment companies, subject to the restrictions of Rule 12d3-1(b). This letter expresses the Division's position on enforcement action only and does not express any legal conclusions on the issues presented.

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Act ICA of 1940
Section
12d3-1
1/24/95
liability

ICA--§12(d)(3)--Rule 12d3-1(d)(1)

September 27, 1994

Jack W. Murphy, Esq.
Chief Counsel
Division of Investment Management
Securities and Exchange Commission
450 Fifth Street, N.W. - Stop 10-6
Judiciary Plaza
Washington, DC 20549

Re: The Royce Funds

Dear Mr. Murphy:

We represent Pennsylvania Mutual Fund, The Royce Fund, Royce Value Trust, Inc. and Royce OTC Micro-Cap Fund, Inc., registered management investment companies (each, a "Fund" and collectively, the "Funds"). We are writing to you, on behalf of the Funds, to request your advice that the staff of the Division of Investment Management (the "Staff") of the Securities and Exchange Commission (the "Commission") interprets section (d)(1) of Rule 12d3-1 (the "Rule") under Section 12(d)(3) of the Investment Company Act of 1940, as amended (the "Act"), in the manner described below, so as to permit the Funds and other registered investment companies and any companies controlled by them to invest in securities issued by persons who are investment advisers not registered under the Investment Advisers Act of 1940, as amended (the "Advisers Act"), to investment companies not registered under the Act. To our knowledge, the Staff has not previously been requested to grant "no action" relief to permit such an investment, and no application for an exemptive order has addressed this issue.

As more fully explained below, Section 12(d)(3) of the Act makes it unlawful for a registered investment company to invest in any security issued by a person who is "an investment adviser of an investment company", and the exemption provided by the Rule does not expressly extend to securities issued by an investment

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adviser to an unregistered investment company. We believe that the Commission has always intended to have the securities of such an issuer covered by the Rule, that the failure of section (d)(1) of the Rule to treat a person's activities as an unregistered investment adviser to an unregistered investment company as "securities related activities" was wholly inadvertent, and that the circumstances that led the Commission to expand the exemptive relief afforded by the Rule in July 1984 and September 1993 warrant the interpretation requested by this letter -- i.e., treating a person's activities as an investment adviser to an unregistered investment company as "securities related activities" for purposes of the Rule.

We are writing this letter on behalf of the Funds, whose investment objectives include long-term capital appreciation, because of the interest of Quest Advisory Corp., their investment adviser, in purchasing for one or more of the Funds publicly-traded securities of foreign issuers that are investment advisers to foreign investment companies.

Section 12(d)(3)

Section 12(d)(3) of the Act reads, in pertinent part, as follows:

"It shall be unlawful for any registered investment company and any company or companies controlled by such registered investment company to purchase or otherwise acquire any security issued by or any other interest in the business of any person who is a broker, a dealer, is engaged in the business of underwriting, or is either an investment adviser of an investment company or an investment adviser registered under title II of this Act"

As the Commission has previously observed, the legislative history of Section 12(d)(3) indicates that its purposes were "principally to prevent investment companies from exposing their assets to the entrepreneurial risks of securities related businesses" and, together with other provisions of the Act, also "to prevent investment companies from being organized, operated, managed, or their portfolio securities selected in the interests of brokers, dealers, underwriters, and investment advisers, whether or not those entities are affiliated persons of the companies." See Exemption for Acquisition by Registered Investment Companies of Securities Issued by Persons Engaged Directly or Indirectly In Securities Related Businesses, Investment Company Act Release No. 13725 (January 17, 1984) (the "1984 Proposing Release").

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The legislative history of Section 12(d)(3) does not explain why (i) Congress believed it necessary to include investment advisers that were not affiliated persons of registered investment companies within Section 12(d)(3)'s prohibitions or (ii) such prohibitions do not extend to investment in the securities of an investment adviser that is not registered under the Advisers Act and does not have an investment company client.

Rule 12d3-1

In any case, as the Commission stated in the 1984 Proposing Release:

"Whatever view is taken of the original purpose of section 12(d)(3), the Commission believes that dramatic changes in the securities industry since 1940 warrant a re-examination of the section's prohibitions. While the section may have been designed to protect investment companies from entrepreneurial risks, and from being managed in the interests of affiliated persons or more generally in the interests of brokers, dealers, underwriters and investment advisers, evidence indicates that today the section often prevents investment companies from making investments that may be in the best interests of their shareholders."

Based on these developments, the Commission, in January 1984, proposed amendments to Rule 12d-1, the predecessor of Rule 12d-3, so that investment companies could have broader exemptive relief from the prohibitions of Section 12(d)(3) as soon as possible. According to both the 1984 Proposing Release and the release adopting the amendments (Exemption for Acquisitions by Registered Investment Companies of Securities Issued by Persons Engaged Directly or Indirectly in Securities Related Businesses, Investment Company Act Release No. 14036 (July 13, 1984) (the "1984 Adopting Release")), the amendments to then Rule 12d-1 would "permit registered investment companies, or companies controlled by registered investment companies, to acquire securities issued by persons that, directly or indirectly, are brokers, dealers, engaged in the business of underwriting, or either investment advisers of investment companies or investment advisers registered under the" Advisers Act. Also, the Conclusion of the 1984 Adopting Release states that the Commission "is adopting revised rule 12d3-1 to provide exemptive relief from Section 12(d)(3) of the Act to enable investment companies to acquire securities issued by persons that, directly or indirectly, are brokers, dealers, underwriters, or investment advisers."

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Unfortunately, the actual language of the 1984 amendments to the Rule, as proposed and as adopted, failed to carry out the Commission's clearly stated intent concerning securities of investment advisers to unregistered investment companies. The proposed amendment's definitions of "securities related activities" and "securities related business" covered, in the case of investment advisers, only those registered under the Advisers Act, and the amendment, as adopted, expanded those definitions in the case of investment advisers only to unregistered investment advisers to "registered" investment companies (thereby including banks (which are generally exempt from the registration provisions of the Advisers Act and therefore are not registered investment advisers) within those definitions). See the 1984 Proposing Release and the 1984 Adopting Release.

Neither the release that proposed eliminating the Rule's two qualitative conditions (Exemption of Acquisitions of Securities Issued by Persons Engaged in Securities Related Business, Investment Company Act Release No. 19204 (January 4, 1993) (the "1993 Proposing Release")) nor the release adopting those amendments (Exemption of Acquisitions of Securities Issued by Persons Engaged in Securities-Related Businesses, Investment Company Act Release No. 19716 (September 16, 1993) (the "1993 Adopting Release")) addressed the reasons for not expanding the Rule's definition of "securities related activities" so as to reach a person's activities as an investment adviser to an investment company, whether registered or unregistered.

That the failures of the 1984 and 1993 amendments to the Rule to include a person's activities as an investment adviser to an unregistered investment company were inadvertent is, however, confirmed by the provisions of the predecessor of the Rule -- i.e., Rule 12d-1. Rule 12d-1, adopted in September 1964 to permit investment companies to purchase securities of issuers that derive no more than 15% of their gross revenues from securities related businesses (subject to certain conditions), covered, in the case of investment advisers, "an investment adviser of an investment company, or an investment adviser registered under the" Advisers Act (paragraph (a)), and thereby reached the securities of all investment advisers otherwise subject to Section 12(d)(3)'s prohibitions.

The inadvertency of such failures is also supported by Note 2 to the Commission's unadopted proposal to relax one of Rule 12d3-1's qualitative conditions in order to permit registered investment companies to acquire the equity securities of foreign securities firms (Acquisition by Registered Investment Companies of the Equity Securities of Foreign Securities Firms, Investment

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Company Act Release No. 17096 (August 3, 1989)), which reads as follows:

"Rule 12d3-1(d)(1) defines 'securities-related activities' as 'a person's activities as a broker, as a dealer, from the business of underwriting, as an investment adviser registered under the Investment Advisers Act of 1940, as amended, or as an investment adviser to a registered investment company.' Section 12(d)(3) of the Act, in pertinent part, prohibits an acquiring company from acquiring any security issued by or any other interest in 'an investment adviser of an investment company.' Proposed amended rule 12d3-1 would track the language in section 12(d)(3) by omitting the word 'registered' from the phrase 'investment adviser to a registered investment company' in the current definition of 'securities-related activities' as well as in the definition of 'securities-related business.' Absent this change, acquiring companies cannot rely on rule 12d3-1 to acquire interests in a company that serves as an investment adviser to an investment company, foreign or domestic, that is not registered with the Commission."

That proposal was never adopted, and the 1993 amendments to the Rule inexplicably failed to address the omission.

We believe that the foregoing history of the Rule demonstrates that the Commission always intended the Rule to include a person's activities as "an investment adviser to an investment company", rather than as "an investment adviser to a registered investment company", within the definition of "securities related activities" contained in section (d)(1) of the Rule, and we would very much appreciate obtaining the Staff's concurrence in our interpretation.

In the event that the Staff does not concur in our interpretation of the term "securities related activities", then we request that the Staff advise us that it will not recommend any enforcement action to the Commission in the event that the Funds and/or any other registered investment companies to which Quest Advisory Corp. or any of its affiliates may hereafter be an investment adviser, invest in the securities of investment advisers to unregistered investment companies as if a person's activities as "an investment adviser to an investment company" were included in the Rule's definition of "securities related activities". In this latter event, we suggest that the Staff

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consider recommending to the Commission an amendment to the Rule's definition to correct this oversight.

Please call me at (212) 940-6340 if any members of the Staff have any comments or questions concerning the above.

Very truly yours,

A handwritten signature in cursive script that reads "Howard J. Kashner". The signature is written in dark ink and is positioned above the printed name.

Howard J. Kashner