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RESPONSE OF THE OFFICE OF CHIEF COUNSEL  
DIVISION OF INVESTMENT MANAGEMENT

Our Ref. No. 96-242  
Merrill Lynch Asset Management  
File No. 801-11583

Your letter of January 30, 1997 requests our assurance that we would not recommend enforcement action to the Commission under section 10(f) or 17(e)(2) of the Investment Company Act of 1940 (the "Investment Company Act"), or section 206(3) of the Investment Advisers Act of 1940 (the "Advisers Act"), if a registered investment company (each a "Fund") advised now or in the future by Merrill Lynch Asset Management, L.P. ("MLAM"), Fund Asset Management, L.P. ("FAM"), or any investment advisory or investment management affiliate of or successor to MLAM or FAM, purchases newly issued securities in transactions in which Merrill Lynch, Pierce, Fenner & Smith Incorporated ("Merrill Lynch") acts as placement agent.

Facts

Merrill Lynch, a registered broker-dealer, is a wholly owned subsidiary of Merrill Lynch & Co., Inc. ("ML & Co"). MLAM and FAM (together, the "Advisers"), both registered investment advisers, also are wholly owned by ML & Co. Because Merrill Lynch and the Advisers are under the common control of ML & Co., ML & Co. and each Adviser are affiliated persons of each other. Because the Advisers are affiliated persons of the Funds they manage, Merrill Lynch is an affiliated person of an affiliated person of each Fund.<sup>1</sup>

You represent that, despite their affiliation, Merrill Lynch and the Advisers are separate entities and operate independently of each other. In particular, you represent that Merrill Lynch and the Advisers operate as independent profit centers, have separate officers, directors and employees, maintain separate books and records, and are separately capitalized.

You represent that all investment decisions with respect to each Fund are made solely by one or more portfolio managers who are officers or authorized agents of the Fund, and who are employed solely by one of the Advisers. Portfolio managers purchase securities for their respective Funds that are consistent with that Fund's investment objectives, based solely on the investment merits and price of the security. You represent that a major determinant of these managers' compensation is the performance of the Funds they manage, and that in no instance is their compensation affected by the amount of business the Funds conduct with Merrill Lynch.

You state that portfolio managers, on behalf of the Funds, often purchase new issues of securities placed directly by the issuer. In these transactions ("direct placement agency

<sup>1</sup>The definition of "affiliated person" is set forth in section 2(a)(3) of the Investment Company Act.

transactions"), the issuer often uses a placement agent to perform services that facilitate the sale of the securities. You explain that in direct placement agency transactions, the placement agent, acting solely as agent for the issuer, agrees only to use its best efforts and incurs no liability if it fails to place the securities. The placement agent typically acts alone, rather than as part of a group formed specifically to sell the securities. In those transactions in which there is more than one placement agent involved, the agents do not have joint responsibility for, or a joint interest in, the outcome of the distribution.

You state that Merrill Lynch frequently acts as placement agent in direct placement agency transactions, and that the extent of Merrill Lynch's participation in these transactions has made it increasingly necessary for the Funds to be able to purchase securities in transactions in which Merrill Lynch acts as placement agent. Your request for relief covers transactions in which a Fund may purchase securities in direct placement agency transactions in which Merrill Lynch acts as placement agent, provided that transactions in securities other than money market instruments (which are the subject of certain exemptive orders granted to the Funds)<sup>2</sup> are conducted in accordance with the following procedures adopted by each Fund's board of directors, including by a majority of the Fund's directors who are not interested persons of the Fund ("disinterested directors"), prior to commencement of the transactions.<sup>3</sup>

1. Prior to each transaction, MLAM or FAM will obtain such information as it deems necessary to determine that the transaction is in the best interests of the Fund. If firms other than Merrill Lynch are also acting as placement agent, MLAM or FAM will solicit a quote as to the security's price from at least one other firm, and that quote will be documented on the trade ticket. In each such instance, MLAM or FAM must determine that the terms of the purchase from Merrill Lynch are at least as favorable as those obtained from the other firm before proceeding with the transaction. If no firm other than Merrill Lynch is acting as placement agent, MLAM or FAM will purchase the securities through Merrill Lynch only if Merrill Lynch represents that the net price to be paid by the Fund for the

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<sup>2</sup>You represent that transactions in money market instruments will comply with the terms of the relevant exemptive order, as it may be amended from time to time, regardless of whether such transactions may technically be considered to be principal or agency transactions. See CMA Tax-Exempt Fund et al., Investment Company Act Rel. No. 15475, Dec. 11, 1986 (notice of application) and Investment Company Act Rel. No. 15520, Jan. 5, 1987 (order); Merrill Lynch Ready Assets Trust et al., Investment Company Act Rel. No. 18693, May 6, 1992 (notice of application) and Investment Company Act Rel. No. 18748, June 2, 1992 (order).

<sup>3</sup>As part of these procedures, Fund portfolio managers and Merrill Lynch traders involved in direct placement agency transactions with Merrill Lynch will be specifically trained with respect to these procedures, and must be approved by the relevant Fund, Adviser, or Merrill Lynch, respectively, to conduct these transactions.

securities will be no higher than the net price to be paid by other purchasers in a comparable transaction of similar quantity with respect to the same securities. In each such instance, the receipt of this representation will be documented on the trade ticket.<sup>4</sup>

2. Merrill Lynch will not charge a Fund any greater commission or other compensation than what is reasonable and customary for such transactions, and in no instance will Merrill Lynch's compensation exceed one percent of the purchase price of the securities.

3. The Advisers will maintain the records needed to confirm compliance with these procedures, including an itemized daily record of all securities obtained from Merrill Lynch in its capacity as placement agent,<sup>5</sup> and a record showing on a daily basis the percentage of the Fund's total assets represented by securities acquired in direct placement agency transactions generally, and separately, the percentage of such transactions conducted with Merrill Lynch.

4. The Advisers will report to each Fund's board of directors on a quarterly basis every direct placement agency transaction conducted with Merrill Lynch as placement agent. These reports will contain, with respect to every transaction, the name of the issuer, the price of the security, the compensation paid to Merrill Lynch by the Fund, whether the trades were solicited, the percentage of the issue purchased by the Fund and by all other Funds in the aggregate, and, if applicable, the quote received from other firms acting as placement agent for the same securities.<sup>6</sup> In addition, the Advisers will monitor these

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<sup>4</sup>In your letter, you raise issues that arise under sections 10(f) and 17(e)(2) of the Investment Company Act and section 206(3) of the Advisers Act. We note that direct placement agency transactions with Merrill Lynch acting as placement agent may give rise to additional issues under these Acts, including section 36(a) of the Investment Company Act and other provisions of section 206 of the Advisers Act. This letter does not address these issues.

<sup>5</sup>You state these itemized daily records will show for each transaction the name and quantity of securities purchased, the percentage of the issue purchased by the Fund individually and by all other Funds in the aggregate, the unit purchase price, the compensation paid, the time and date of the transaction, and either (1) if firms other than Merrill Lynch also are acting as placement agent for that security issuance, the price quoted from at least one such firm, the name of that firm, and the time and date the quotation was received, or (2) if no firm other than Merrill Lynch is acting as placement agent, that the representation that the net price to be paid by the Fund will be no higher than the net price to be paid by other purchasers in comparable transactions of similar quantity with respect to the same securities has been received from Merrill Lynch.

<sup>6</sup>You represent that the Advisers will preserve all records set forth in numbered paragraphs 3 and 4 above for a period not less than six years from the end of the last fiscal year in which any transactions occurred, the first two years in an easily accessible place. In addition, you

transactions continuously and report promptly to the relevant Fund's board of directors any instances in which the procedures were not followed.

5. On at least a quarterly basis, the Fund's board of directors, including a majority of the Fund's disinterested directors, will determine (1) whether direct placement agency transactions with Merrill Lynch have been, and will continue to be, consistent with the best interests of the Fund and its shareholders, and (2) whether all of the transactions effected during the past quarter complied with the procedures.<sup>7</sup> In addition, a majority of either the Fund's board of directors or the Fund's disinterested directors will amend or supplement these procedures with other measures at any time if such actions appear to be consistent with the best interests of the Fund and its shareholders.<sup>8</sup> Further, the practice of engaging in direct placement agency transactions with Merrill Lynch may be terminated at any time by a majority vote of either the Fund's board of directors or the Fund's disinterested directors.

#### Analysis

##### 1. Sections 10(f) and 17(e)(2) of the Investment Company Act

Section 10(f) of the Investment Company Act, in relevant part, generally prohibits a registered investment company from purchasing a security during the existence of any underwriting or selling syndicate when the company's investment adviser, or an affiliate of the investment adviser, is one of the principal underwriters of the security. Section 10(f) was designed primarily to prevent an underwriter from "dumping" securities on an affiliated investment company in order to stimulate the market in these securities or to relieve the underwriter or selling syndicate of securities that are otherwise unmarketable.<sup>9</sup>

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represent that the Advisers will preserve permanently in an easily accessible place a written copy of the procedures adopted by each Fund's board of directors and any modifications and supplements subsequently made to them. Telephone conversation of April 16, 1997 between Rochelle Kauffman Plesset and Brian Kaplowitz of Brown & Wood.

<sup>7</sup>You represent that the minutes of each board meeting at which these determinations are to be made will reflect in detail the reasons for the determinations.

<sup>8</sup>Telephone conversation of March 6, 1997 between Rochelle Kauffman Plesset and Brian M. Kaplowitz of Brown & Wood.

<sup>9</sup>See National Aviation Corp., 23 SEC 550, 552 (1946). See also Report of the Securities and Exchange Commission, Investment Trusts and Investment Companies, Part Three, Chapter VII, "Abuses and Deficiencies in the Organization and Operation of Investment Trusts and Investment Companies," H.R. Doc. No. 136, 77th Cong., 1st Sess. 2581, 2589 (1940) (discussing the frequent practice of investment company sponsors "dumping" unmarketable

Section 17(e)(2) of the Investment Company Act governs the purchase or sale of securities on behalf of a registered investment company when a person affiliated with the company acts as broker. These transactions are regulated by placing a limit on the compensation the affiliated person may receive. Section 17(e)(2)(C) (which, assuming Merrill Lynch is acting as broker within the meaning of section 17(e)(2), is applicable to the transactions described in your letter), limits compensation to one percent of the purchase or sale price of the securities. Congress designed section 17(e)(2) to address potential conflicts of interests that could arise when a broker arranges a securities transaction for an affiliated investment company.

You maintain that section 10(f) does not apply to investment company purchases of securities in direct placement agency transactions in which the company's investment adviser, or an affiliate of the investment adviser, acts as placement agent. You state that Congress intended section 10(f) to apply only when (1) securities in an underwriting are sold through a syndicate organized for the purpose of distributing the securities, and (2) the investment company purchases securities from a syndicate member other than the affiliated person.

First, you maintain that section 10(f) does not apply to direct placement agency transactions because no syndicate is formed to distribute the securities. In your view, a syndicate exists only when two or more parties, organized in a group formed for the purpose of selling an issue of securities, have a joint responsibility for and a financial commitment to the distribution of the issue (*i.e.*, the underwriting is on a firm commitment (principal) rather than a best efforts (agency) basis). You maintain that no syndicate exists in direct placement agency transactions because the placement agent typically acts alone and places the securities on a best efforts basis.

Second, you contend that section 10(f) does not apply to an investment company's purchase of securities through an affiliated person in the course of an underwriting. Instead, you maintain that Congress intended section 17 to be the sole provision governing transactions directly between an investment company and its affiliated persons. You thus conclude that the Funds may enter into direct placement agency transactions in which Merrill Lynch acts as placement agent provided that Merrill Lynch complies with the compensation limits set forth in section 17(e)(2)(C).

The staff has expressed the view that direct private placement transactions can in some instances present the same types of concerns that prompted Congress to enact section

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securities on affiliated investment companies prior to the adoption of the Investment Company Act) ("SEC Report").

10(f).<sup>10</sup> We believe, however, that your representations and the procedures you propose to follow adequately address these concerns.

Based on the facts and representations in your letter and as described above, and without necessarily agreeing with your legal analysis that section 10(f) does not apply to any direct placement agency transaction involving an investment company and its affiliated persons, we would not recommend that the Commission take any enforcement action under section 10(f) or 17(e)(2) if the Funds participate in direct placement agency transactions in which Merrill Lynch acts as placement agent. This position is based particularly on your representations that (1) Merrill Lynch and the Advisers are separate entities and operate independently of each other, (2) the manager's compensation is not affected by the amount of business the Fund conducts with Merrill Lynch, (3) Merrill Lynch will incur no liability to an issuer if it fails to place the securities, and (4) the transactions will be conducted in accordance with procedures, described above, that will be approved by each Fund's board of directors, including a majority of the Fund's disinterested directors.

## 2. Section 206(3) of the Advisers Act

Section 206(3) makes it unlawful for any investment adviser, acting as principal for its own account, knowingly to sell any security to or purchase any security from a client, or acting as broker for a person other than a client, knowingly to effect any sale or purchase of any security for the account of such client, without disclosing to the client in writing before the completion of the transaction the capacity in which he is acting and obtaining the client's consent to the transaction. Section 206(3) is intended to address the potential for self-dealing that could arise when an adviser acts as principal in a transaction with clients or as agent in connection with a transaction on behalf of a client.<sup>11</sup> Congress' decision to address this

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<sup>10</sup>John Nuveen & Co. Incorporated (pub. avail. Jan. 24, 1989). Specifically, a placement agent could "dump" unmarketable securities on an investment company with which it is affiliated in order to receive commissions and to enhance its reputation among issuers as being able to sell "difficult to place" securities and thus attract additional business. See SEC Report, *supra* note 9, at 2535-36 ("The control of an investment company by an investment banker naturally impresses the client, who desires to be financed, with the resources that the investment banker may call upon to make the financing operation successful, such as, selling some of the securities to the investment company, securing the company's participation in the underwriting commitment, including the company in trading accounts or using the company's funds in stabilizing the market.").

<sup>11</sup>See Investment Trusts and Investment Companies: Hearings on S. 3580 Before the Subcomm. of the Comm. on Banking and Currency, 76th Cong., 3d Sess. 320 (1940) ("I think it is the Commission's recommendation that all self-dealing between the investment counselor and the client should be stopped.") (statement of David Schenker).

concern by requiring disclosure and client consent, rather than by prohibiting these types of transactions, suggests that Congress recognized that some of these transactions could be beneficial to clients.<sup>12</sup>

The Commission and the staff have applied section 206(3) to situations in which the adviser causes a client to enter into a principal or agency transaction effected by a broker-dealer that controls, is controlled by, or is under common control with, the adviser.<sup>13</sup> Thus, because the Advisers would cause the Funds to enter into direct placement agency transactions in which Merrill Lynch would act as placement agent, the transactions would be subject to section 206(3).

You state that the Advisers will meet the disclosure and consent requirements of section 206(3) by having a Fund's portfolio manager, who is also an officer or authorized signatory of the Fund, enter into a transaction on behalf of the Fund, thereby providing the required consent.<sup>14</sup> You maintain that, when a fund is organized as a corporation or as a Massachusetts business trust, it acts through its officers or agents, and that in the case of a portfolio manager of a fund, the officer or agent has full authority to purchase and sell securities. You also represent that such persons have knowledge of the information that is required to be disclosed under section 206(3).<sup>15</sup> Thus, you assert that these persons can

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<sup>12</sup>Rule 206(3)-2 under the Advisers Act provides a non-exclusive method of compliance with the provisions of section 206(3) in connection with certain agency cross transactions for advisory clients. The rule permits an adviser or broker-dealer that controls, is controlled by or is under common control with the adviser to conduct agency cross transactions without making the required disclosure and obtaining client consent prior to each transaction, provided that certain conditions are met. The safe harbor is unavailable when either the adviser or broker affiliate (alone or collectively) recommends the transaction to both the seller and the purchaser, and thus would be unavailable to Merrill Lynch in connection with direct placement agency transactions.

<sup>13</sup>See Agency Cross Transactions for Advisory Clients, Advisers Act Rel. No. 589 (May 31, 1977), 42 FR 29300 (June 8, 1977); In the Matter of Calamos Asset Management Inc., Advisers Act Rel. No. 1594 (Admin. Proc. File No. 3-9166) (Oct. 16, 1996); In the Matter of Concord Investment Company, Advisers Act Rel. No. 1585 (Admin. Proc. File No. 3-9109) (Sept. 27, 1996); Hartzmark & Co., Inc. (pub. avail. Nov. 11, 1973); Interplan Securities Corp. (pub. avail. Feb. 23, 1978).

<sup>14</sup>You maintain that in this situation, imposing the disclosure requirements of section 206(3) would be tantamount to requiring the portfolio manager to make written disclosures to himself.

<sup>15</sup>Telephone conversation of March 6, 1997 between Rochelle Kauffman Plesset and Brian M. Kaplowitz of Brown & Wood.

receive notice and give consent for purposes of section 206(3), even if the person giving consent is also an employee of, or is otherwise affiliated with, the adviser.

Based on the facts and representations in your letter and as discussed above, we would not recommend that the Commission take any enforcement action under section 206(3) if the Advisers cause the Funds to engage in direct placement agency transactions in which Merrill Lynch acts as placement agent. This position is based particularly on your representation that the transactions will be conducted in accordance with procedures (in particular, those described in numbered paragraphs 1, 4 and 5 of our response) approved by the Fund's board of directors, including a majority of the Fund's disinterested directors, prior to commencement of the transactions.

You should note that any different facts or circumstances might require a different conclusion with respect to each of your questions.

*Rochelle Kauffman Plesset*  
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Investment Company Act of 1940  
Section 10(f)  
Section 17(e)

Investment Advisers Act of  
1940 Section 206(3)

January 30, 1997

Office of Chief Counsel  
Division of Investment Management  
Securities and Exchange Commission  
450 Fifth Street, N.W.  
Judiciary Plaza  
Washington, D.C. 20549

Re: Merrill Lynch Asset Management

Ladies and Gentlemen:

Set forth below is our revised and restated request on behalf of Merrill Lynch Asset Management, L.P. ("MLAM") and Fund Asset Management, L.P. ("FAM"), that you confirm that the Division of Investment Management (the "Division") will not recommend that the Securities and Exchange Commission (the "Commission") take any enforcement action under Section 10(f) or Section 17(e) of the Investment Company Act of 1940 (the "Investment Company Act") or Section 206(3) of the Investment Advisers Act of 1940 (the "Advisers Act") if registered investment companies of which MLAM or FAM is the investment adviser purchase newly issued securities in transactions in which Merrill Lynch, Pierce, Fenner & Smith Incorporated ("Merrill Lynch"), an affiliated person of MLAM and FAM, acts as placement agent.<sup>1</sup>

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<sup>1</sup> The above request also is intended to encompass any registered investment company organized in the future and advised or managed by MLAM or FAM, or any investment advisory or investment management affiliate or successor of MLAM or FAM.

I. Background

A. Description of the Parties and the Subject Transactions.

MLAM and FAM (together, the "Advisers") act as investment adviser to over 130 registered investment companies (each a "Fund"). Under each Fund's investment advisory or management agreement, either MLAM or FAM, subject to the general supervision of the directors or trustees of the Fund, provides investment advisory and management services.

Merrill Lynch, a wholly-owned subsidiary of Merrill Lynch & Co., Inc. ("ML & Co."), is a registered broker-dealer and conducts a diversified securities business. The Advisers, which are also owned and controlled by ML&Co., are "affiliated persons" of the Funds and of Merrill Lynch within the meaning of Section 2(a)(3) of the Investment Company Act. Accordingly, Merrill Lynch is an affiliated person of an affiliated person of the Funds.

Despite their affiliation, Merrill Lynch and the Advisers operate as completely separate entities under the umbrella of the ML & Co. holding company. While Merrill Lynch and the Advisers are under common control, they have their own separate directors, officers and employees, each is separately capitalized and each maintains its own separate books and records and operates as an independent profit center<sup>2</sup>. Consequently, the Advisers operate completely independently of Merrill Lynch in performing portfolio management services.

In accordance with the foregoing, all purchase decisions by the Funds are determined solely by the Advisers. In that regard, investments for the Funds are the responsibility of one or more individuals employed solely by MLAM or FAM, and who also are officers or agents of the Fund concerned. These portfolio managers are not employees of Merrill Lynch, and their lines of reporting responsibility are solely within MLAM or FAM. In addition, a major determinant of their compensation is the performance of the Fund or Funds over which they have responsibility. In no instance is their compensation affected by the amount of business done with Merrill Lynch.

The Funds purchase securities in accordance with their investment objectives either as new issues or in secondary market transactions. New issues of securities are often sold in underwritten offerings. In other instances, securities may be

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<sup>2</sup> No director, officer or employee of the Funds is also a director, officer or employee of Merrill Lynch.

directly placed by the issuer. The circumstances surrounding direct placements purchased by the Funds are the subject of the instant no-action request. Our request is made on behalf of all of the Funds and is intended to be relied upon for all types of directly placed securities. We have attempted to provide some general description of direct placement agency transactions and of the procedures pursuant to which the Funds will engage in such transactions with Merrill Lynch. However, we note that although the transactions described herein are all conducted on an agency basis, the nature and mechanics of direct placements of securities may differ significantly depending on the type of securities involved. Thus, a placement of tax-exempt securities may be conducted in a manner different, for example, than a placement of short-term U.S. government notes or equity securities.

In direct placement agency transactions the issuer often uses a securities firm or bank as placement agent, performing services that facilitate the sale of the securities. The placement agent acts solely as an agent for the issuer. As discussed further herein, the agent does not participate in an underwriting or selling syndicate as contemplated by Section 10(f) of the Investment Company Act. Thus, in performing its functions the placement agent agrees only to use its best efforts and has no liability on account of any failure to sell the securities concerned; the agent does not commit to purchase securities for its own account and incurs no financial risk in the sales of the securities. In addition, the bank or securities firm acts alone and in an individual capacity in selling the securities, rather than as part of a group formed for that purpose. Similarly, even where there is more than one entity involved in a direct placement, such entities do not have the joint responsibility for or joint interest in the outcome of the distribution such as typically exists in a syndicate.

A Fund's determination of whether to purchase securities in a direct placement agency transaction, as is the case with other purchase decisions, depends on the investment merits and price of the security. In making that determination, the portfolio managers will review whatever information they believe necessary to make an informed decision. As is the case with all purchase transactions in the primary market, the degree to which the terms of the transaction may be subject to negotiation will vary depending, among other things, on the issuer, the type of security involved and the other circumstances under which the placement is made. That also will be the case in all transactions with Merrill Lynch. Further, the Advisers undertake that if and for so long as the Division is unable to concur as an interpretative matter with the view that Section 10(f) does not apply to direct placement agency transactions, any such

transactions with Merrill Lynch in securities other than money market instruments of the type which are the subject of certain exemptive orders granted to the Funds <sup>3</sup>, will be conducted only pursuant to procedures adopted by the boards of directors of the Funds, including by a majority of those directors ("Independent Directors") who are not "interested persons" of the Funds within the meaning of Section 2(a)(19) of the Investment Company Act.

The relevant procedures will be based generally on those governing transactions of the Funds that are subject to Rule 10f-3 under the Investment Company Act and on the guidelines adopted by certain of the Funds pursuant to the above exemptive orders. These procedures will be substantially as follows:

1. Before any direct placement agency transaction may be conducted with Merrill Lynch, MLAM or FAM, on behalf of the Fund, will be required to obtain such information as it deems necessary to determine that the transaction is in the best interests of the Fund. In addition:

- (a) If firms other than Merrill Lynch are also placing the securities under consideration, then MLAM or FAM, on behalf of the Fund, will be required to solicit a quote as to the price of the relevant security from at least one such firm. The quote will be documented on the trade ticket. In each instance, a determination will be made that the terms of the purchase from Merrill Lynch are at least as favorable as those obtained from the other available sources, if any, and such determination will be documented; and
- (b) If no firm other than Merrill Lynch is placing the securities under consideration, MLAM or FAM, on behalf of the Fund, will purchase such securities through Merrill Lynch only if Merrill Lynch first represents to MLAM or FAM, as the case may be, that the net price being paid by the Fund is no greater than the net price being paid for such securities by any other customer of Merrill Lynch purchasing such securities in a contemporaneous transaction of similar quantity. Receipt of such representation will be documented on the trade ticket.

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<sup>3</sup> See Investment Company Act Release Nos. IC-15520 (tax exempt instruments) and 18748 (taxable instruments), January 5, 1987 and June 2, 1992, respectively. The Advisers undertake that transactions in the above types of money market instruments will comply with the terms of the relevant exemptive order, as it may be amended from time to time, regardless of whether such transactions may technically be considered principal transactions or agency transactions.

2. In no instance will the compensation to Merrill Lynch for securities purchased by the Funds exceed one percent of the purchase price of the securities purchased by the Funds. Moreover, Merrill Lynch will not charge the Funds any greater commission or other compensation than what is reasonable and customary for such transactions.

3. The traders at Merrill Lynch and the Fund portfolio managers involved in any direct placement agency transactions with Merrill Lynch will be required to be thoroughly familiar with these procedures, will be briefed specifically thereon and will be approved specifically to conduct such transactions. Responsibility for such briefings and approvals in the case of a Fund and the Advisers will rest with the Secretary of the Fund and counsel for the Advisers and, in the case of Merrill Lynch, will rest with the Law and Compliance Division of Merrill Lynch. In the training of personnel of Merrill Lynch, particular emphasis will be given to the fact that a Fund is to be charged no greater commission or other compensation than what is reasonable and customary for such transactions.

4. MLAM or FAM, on behalf of each Fund engaging in direct placement agency transactions with Merrill Lynch, will be required to maintain such records with respect to those transactions as may be necessary to confirm compliance with these procedures. In that regard MLAM or FAM, on behalf of each Fund, will maintain:

(a) an itemized daily record of all purchases of securities encompassed hereby, showing for each transaction: the name and quantity of securities; the percentage of the issue being purchased by the Fund and by all other Funds in the aggregate; the unit purchase price; the commission or other compensation paid; and the time and date of the transaction. Such records also will: (i) for each transaction in the specific security for which a firm other than Merrill Lynch acts as placement agent, document the quotation received from such other firm, including: the name of the firm, the name of the securities, the price quoted, and the time and date the quotation was received; and (ii) for each transaction in a specific security for which no firm other than Merrill Lynch acts as placement agent, document receipt of the representation described in paragraph 1(b) above; and

(b) a ledger or other record showing, on a daily basis, the percentage (based on dollar amount) of the Fund's total assets represented by securities acquired in direct placement agency transactions generally, and separately, the

percentage (based on dollar amount) of such transactions entered into with Merrill Lynch.

5. MLAM or FAM, on behalf of each Fund, will be required to continuously monitor direct placement agency transactions with Merrill Lynch and report immediately to the board of directors of the relevant Fund any deviation from the above requirements.

6. MLAM or FAM will report to the board of directors of each Fund on a quarterly basis each direct placement agency transaction by that Fund with Merrill Lynch. Those reports will include the name of the issuer, the price of the security, the commission or other compensation paid to Merrill Lynch, an indication of whether or not the trades were solicited, the percentage of the issue purchased by the particular Fund and by all other Funds, in the aggregate, and, if available, the quotation received from other agents for the same securities.

7. The board of directors of each Fund, including a majority of the Independent Directors, will review no less frequently than quarterly the Fund's participation in direct placement agency transactions with Merrill Lynch and determine (a) whether transactions effected during the prior quarter complied with the above procedures, and (b) whether the Funds's participation in direct placement agency transactions with Merrill Lynch has been and continues to be in the best interests of the Fund and its shareholders. The minutes of the board meeting at which these determinations are made will reflect in detail the reasons for the determinations.

8. The board of directors of each Fund, including a majority of the Independent Directors acting separately, have the ability at all times to amend or supplement the procedures, or to terminate the ability of the Fund to engage in direct placement agency transactions with Merrill Lynch.

#### B. Legal Background.

Merrill Lynch is a major participant in the primary new issue market for all types of securities. The extent of Merrill Lynch's participation in these markets has made it increasingly necessary for the Funds to be able to purchase securities in transactions where Merrill Lynch acts as placement agent. However, since, as noted above, the Funds and Merrill Lynch may be considered second-tier affiliated persons, the Investment Company Act places certain strictures on such purchases.

The Investment Company Act, in effect, divides purchase and sale transactions between an investment company and its

affiliated persons into two basic categories, principal transactions and agency transactions. Principal transactions with an affiliated person were viewed as so potentially harmful to the investment companies involved that such transactions were prohibited outright in Section 17(a) of the Investment Company Act. See S. Rep. No. 1775, 76th Cong., 3d Sess. 14 (1940).<sup>4</sup> For example, Congress was concerned about the "unloading of securities upon [investment] companies" and the possibility that affiliated persons may sell "worthless securities at extravagant prices to their controlled companies." *Id.* at 7; H.R. Rep. No. 2639, 76th Cong., 3d Sess. 9 (1940). Congress saw that an affiliated person holding valueless securities might be tempted to use the investment company to avoid a loss of the amount paid for such securities. Those concerns were not considered to exist to the same degree, however, in the context of agency transactions where the commission payable to the affiliated person was appropriately limited; while problems such as the "unloading" of securities could theoretically exist in those situations, Congress believed that the incentive to do so could be eliminated by restricting the amount by which the affiliated person could profit from such activities. Thus, as relevant here, the primary restriction that the Investment Company Act places on investment company purchases from an affiliated placement agent concerns the compensation of the agent.

By acting as placement agent in direct placement agency transactions, the affiliated person functions as a broker and, therefore, is subject to Section 17(e) (2) of the Investment Company Act. Section 17(e) (2) provides that:

It shall be unlawful for any affiliated person of a registered investment company, or any affiliated person of such person . . . acting as broker, in connection with the sale of securities to or by such registered company or any controlled company thereof, to receive from any source a commission, fee, or other remuneration for effecting such transaction which exceeds (A) the usual and customary broker's commission if the sale is effected on a securities exchange, or (B) 2 per centum of the sales price if the sale is effected in connection with a secondary distribution of such securities, or (C) 1 per centum of the purchase or sale price of such securities if the sale is otherwise effected unless the Commission shall, by rules and regulations or order in the public interest and

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<sup>4</sup> Section 17(b) authorizes the Commission to grant exemptions from the provisions of Section 17(a).

consistent with the protection of investors, permit a larger commission.<sup>5</sup>

Consequently, in the present situation, Merrill Lynch could not receive compensation from any source in connection with its role as placement agent for securities purchased by the Funds if such compensation exceeded one percent of the purchase or sale price.<sup>6</sup>

The Division previously confirmed the applicability of Section 17(e)(2) to direct placement agency transactions in the no-action letter of John Nuveen & Co., Inc. (available January 24, 1989) (the "1989 letter"). A no-action position was requested in the 1989 letter under Section 17(e) in order that a group of investment companies could purchase tax-exempt securities in transactions involving as placement agent the broker-dealer affiliate of the investment adviser to such investment companies.

The 1989 letter also was submitted under Section 10(f) of the Investment Company Act and Rule 206(3)-2 of the Advisers Act. Section 10(f) of the Investment Company Act generally prohibits an investment company from purchasing any securities from a member of an underwriting syndicate of which an affiliated person of the investment company is a participant.<sup>7</sup> In that regard, Section 10(f) prevents circumvention of the policies underlying Section 17(a) by an affiliated person indirectly engaging in

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<sup>5</sup> Agency transactions between an investment company and its affiliated persons not involving brokerage functions are subject to even greater restrictions. Specifically, Section 17(e)(1) prohibits any affiliated person of an investment company from accepting any compensation for acting as agent in connection with the sale of any property by or to the company.

<sup>6</sup> The Advisers believe, for example, that the typical placement agent compensation in the case of long-term tax-exempt securities is in the range of 60 to 150 basis points (although the 100 basis point limit of Section 17(e)(2)(C) would apply to transactions subject to the instant request). The compensation in the case of taxable securities varies, depending on the type of security and several other factors. As one example, the typical compensation in the money market area is in the range of 5 to 12.5 basis points.

<sup>7</sup> Rule 10f-3 under the Investment Company Act provides limited exemptive relief from the provisions of Section 10(f).

principal transactions through an ostensibly unrelated syndicate member. Rule 206(3)-2 under the Advisers Act provides a safe harbor from the provisions of Section 206(3) of the Advisers Act. That Section generally requires that an investment adviser make certain written disclosures to and obtain the consent of its client prior to engaging in any principal or agency transactions with the client.

We are presently seeking a no-action position primarily because of the need to clarify the applicability of Sections 10(f) and 206(3) to direct placement agency transactions. The need for such clarification is not limited to the situation of the Funds. The ability to make the desired purchases is important to the investment company industry on the whole.

## II. Discussion

### A. Applicability of Sections 10(f) and 17(e) to Direct Placement Agency Transactions

It is our view that direct placement agency transactions involving an investment company and its affiliated persons are not within the purview of Section 10(f). Rather, we believe that Section 17(e) was intended by Congress to provide the necessary protection against any potential abuses inherent in such transactions. Our conclusion, as described in more detail below, is based primarily on a review of the role of Section 17(e) in the statutory scheme and on an examination of the language and legislative history of Section 10(f) itself.

We respectfully request that the Division confirm our interpretation that Section 17(e), but not Section 10(f), applies to direct placement agency transactions. If the Division does not concur with our interpretation, however, we request that the Division not recommend that the Commission take any enforcement action under Section 10(f) or Section 17(e) if Merrill Lynch acts as placement agent in connection with purchases of Securities by the Funds. In this event, all transactions with Merrill Lynch of the type described in this request will be subject to procedures substantially as described above.<sup>8</sup> While it is not relevant to our legal analysis, we also note that the prospectuses or

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<sup>8</sup> In addition, direct placement transactions with Merrill Lynch would be appropriately reported to the Commission in response to Item 77(o) of Form N-SAR. As mentioned earlier, however, transactions in money market instruments will instead comply with the procedures set forth in the exemptive orders cited supra note 3.

statements of additional information, or both, for each of the Funds already disclose the possibility that the Funds may conduct transactions on an agency basis with Merrill Lynch. Those documents also disclose for Funds that are open-end investment companies the aggregate dollar amount of brokerage commissions paid to Merrill Lynch during the last fiscal year and such other related information as is required by Form N-1A.

Section 10(f) of the Act provides, in pertinent part:

No registered investment company shall knowingly purchase or otherwise acquire, during the existence of any underwriting or selling syndicate, any security . . . a principal underwriter of which is an officer, director, member of an advisory board, investment adviser, or employee of such registered company, or is a person . . . of which any such officer, director, member of an advisory board, investment adviser, or employee is an affiliated person . . . . (emphasis added)

An argument could be made that since Section 10(f) was intended to regulate certain distributions of securities (i.e., offerings involving an underwriting or selling syndicate), the Section should be viewed as encompassing any type of transaction that could be argued to have some element of a distribution. Under such a reading of Section 10(f), that Section would govern any primary market transaction in securities by an investment company where an affiliated person of the company was involved. We do not believe the Section may properly be read that broadly. It is our view that Section 17 of the Investment Company Act, not Section 10(f), governs transactions directly between an investment company and its affiliated persons. In addition, we believe that Section 10(f) applies only where there is a syndicate organized for the distribution of the securities in question. We believe the Section to be inapposite where securities are directly placed either by a sole placement agent or by more than one placement agents, provided that there is no joint responsibility as between such agents to distribute the issue and that there is lacking the type of financial risk that characterizes a syndicate.

Transactions directly between an investment company and its affiliated persons, whether agency transactions such as direct placements or principal transactions, are provided for solely and expressly by Section 17 of the Investment Company Act. Moreover, as discussed earlier, the statutory scheme reflects a dichotomy in which agency transactions are not viewed as presenting the same potential for harm to an investment company as that presented by principal transactions, whether such principal

transactions are engaged in directly by the affiliated person or, as relevant here, indirectly through the use of an unrelated syndicate member. In that regard, Section 17(e)(2) specifically reflects Congress' belief that where the affiliated person is acting as broker, protection against potential conflicts of interest is best afforded by limitations on the amount of compensation that may be received by the affiliated person. See H.R. Rep. No. 2639, 76th Cong., 3d Sess. 9, 17-18 (1940). See also United States v. Deutsch, 451 F.2d 98, 108 (2d Cir. 1971), cert. denied, 404 U.S. 1019 (1972). Indeed, the Senate Report accompanying the original bill stated that: "In general, agency transactions are not affected . . . , but brokerage commissions are limited in the main to standard rates with provision for special exemptions." See S. Rep. No. 1775, 76th Cong., 3d Sess. 14, 15 (1940).

There is no evidence that Congress believed that a primary market transaction or any other transaction arguably resembling a distribution of securities requires the application of Section 10(f) to provide the necessary investor protection. Indeed, Section 17(e)(2) itself applies directly to distribution or underwriting activities. While the Section refers only to a person acting as "broker", it is common for a broker's activities to include participation in a distribution or underwriting of securities. Moreover, the Section expressly contemplates a broker receiving compensation in connection with a secondary distribution of securities where the broker's affiliated investment company either purchases or sells securities in the distribution. Participation in a secondary distribution, as with any other distribution, involves underwriting activities.<sup>9</sup> As recognized by David Schenker, Chief Counsel to the Commission's study of investment trusts and investment companies which led to the enactment of the Investment Company Act, while Section 17(e) generally prohibits an affiliated person acting as agent from accepting any compensation with respect to purchases or sales by

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<sup>9</sup> Secondary distributions of securities, while not involving the issuer as the seller of such securities, present many of the same securities laws issues as primary offerings of securities. For example, absent an available exemption, secondary distributions require registration by the issuer of the securities under the Securities Act of 1933. See generally, Loss and Seligman, Fundamentals of Securities Regulation, 322-356 (3d. Ed. 1995). Primary and secondary distributions are also viewed similarly under certain provisions of the Securities Exchange Act of 1934. See, e.g., Rule 10b-6 (paragraph (c)(5) of Rule 10b-6 brings within the Rule's scope any type of distribution, whether primary or secondary).

an investment company, such person "can act as broker for the [investment company] and he can act as the underwriter or the distributor of securities." See Investment Trusts and Investment Companies: Hearings on S.3580, Before the Subcomm. on Securities and Exchange of the Senate Comm. on Banking and Currency, 76th Cong., 3d Sess. 262 (1940) (the "Senate Hearings"). We view that statement, and the language of the Section itself, as treating brokerage, underwriting and distribution activities in the conjunctive, not the disjunctive. Similarly, one of the principal industry participants in the development of the Investment Company Act stated in a law review article written shortly after enactment of the statute that:

Section 17 . . . limits the commission which any affiliated person may receive when acting as broker for an investment company. While he may act as broker in the distribution of securities owned by an investment company, he cannot act as distributor if the transaction takes such form that the affiliated person buys for his own account in making the distribution.  
(emphasis added)

Jaretzki, The Investment Company Act of 1940, 26 Wash. U.L.Q. 303, 321-322 (1941).<sup>10</sup>

Surely if Congress intended in Section 17(e) to permit an affiliated person of an investment company to receive compensation for acting as broker in connection with purchases of securities by the company in the context of a distribution, Congress must not have intended at the same time to prohibit such purchases through the application of Section 10(f). It is a rule of statutory construction that "unreasonableness of the result produced by one among several possible interpretations of a statute is reason for rejecting that interpretation in favor of another which would produce a reasonable result." 2A Sutherland Statutory Construction § 45.12 (4th Ed. 1984) ("Sutherland"). Similarly, since Section 17(e) specifically refers to agency transactions in the context of a distribution, it should be viewed as controlling over the more general language contained in Section 10(f). Specific provisions in a statute control more general provisions. See Sutherland at § 46.05. The Commission has recognized the statutory interplay of Sections 10(f) and 17.

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<sup>10</sup> We recognize that the situation posed by the cited language might be construed as contemplating only circumstances where the affiliated person is acting as broker in connection with a sale of securities by the investment company. We note, however, that Section 17(e)(2) refers both to purchases and sales by the investment company.

For example, the Commission stated in Investment Company Act Release No. 14924 (January 29, 1986) (advance notice and request for comment with respect to Section 10(f) and Rule 10f-3 thereunder) ("Release 14924") that:

When Congress was considering legislation in 1940 to regulate the investment company industry concern was voiced over underwriters "dumping" otherwise unmarketable securities on affiliated investment companies, either by forcing the investment company to purchase unmarketable securities from the underwriting affiliate itself, or by forcing or encouraging the investment company to purchase such securities from another member of the syndicate. Concern was also expressed over the level of underwriting fees earned by affiliated underwriters in connection with the transactions.

In response to these concerns, Congress included section 10(f) in the Investment Company Act to prevent any registered investment company from purchasing or otherwise acquiring any security during the existence of any underwriting or selling syndicate where a principal underwriter of the security is affiliated with the investment company except under limited circumstances. Since section 17(a) . . . . prevents an investment company from acquiring any securities directly from an affiliate or from an affiliate of an affiliate, the purpose of section 10(f) is to prevent an investment company from acquiring any securities from an unaffiliated member of the underwriting syndicate on the premise that the affiliate still has the potential to pressure the investment company into making the purchase in order to facilitate the underwriting. (emphasis added)

Similarly, in Investment Company Act Release No. 21838 (March 21, 1996) ("Release 21838"), announcing proposed amendments to Rule 10f-3, the Commission stated:

Even in the absence of section 10(f), a fund effectively would be prohibited by Section 17(a) of the Investment Company Act from purchasing securities directly from its affiliated underwriters or from an affiliate of its affiliate . . . . That section 10(f) prevents a fund from acquiring securities from an unaffiliated member of the underwriting syndicate would seem to reflect the view that the affiliated underwriter has the potential to pressure the fund into acquiring the securities through another underwriter in order to facilitate the underwriting . . . .

While the quoted language alludes to principal transactions and, therefore, to Section 17(a), it follows logically that the Commission would view Section 17(e) as the sole provision governing agency transactions directly between an investment company and its affiliated persons.

The obvious question is that if Section 17(e) governs agency transactions between an investment company and its affiliated persons even in a situation resembling a distribution, to what transactions does Section 10(f) extend? We believe the answer is that Section 10(f) was intended to cover only purchases (a) during the existence of an underwriting or selling syndicate (i.e., where two or more parties have a joint responsibility for and a financial commitment to the distribution of the issue) and (b) where the purchases are made from a member of the syndicate other than the affiliated person.

That Section 10(f) applies only to situations involving a syndicate where the investment company purchases securities from a syndicate member other than the affiliated person is made evident by the express language of the Section. Section 10(f) specifically states that it applies during the existence of an underwriting or selling "syndicate". While the Investment Company Act does not define the term "syndicate", the meaning of the term is clear. Webster's Third New International Unabridged Dictionary defines "syndicate" as "a group of persons or concerns who combine under a usually temporary agreement to carry out a particular transaction ([such as] investment houses for underwriting a bond issue)." No syndicate exists where an affiliated person is acting as a placement agent in a direct placement of securities. Even where there is more than one placement agent the joint effort characteristic of an underwriting would be lacking; for example, in a direct placement agency transaction there are typically no agreements between the agents coordinating the selling effort. Moreover, as the Commission and its staff apparently have recognized, a syndicate should not be deemed to exist under Section 10(f) unless the members thereof have a financial commitment to the distribution or otherwise incur a financial risk in connection with the securities being distributed. See Institutional Liquid Assets (pub. avail. December 16, 1981).<sup>11</sup> In Release 21838, supra page 13, at note 64 thereof, the Commission cited the Institutional Liquid Assets letter in stating that "it may not be necessary for rule 10f-3 to permit the purchase of U.S. Government securities because the arrangements among distributors

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<sup>11</sup> We acknowledge, however, that the situation in Institutional Liquid Assets did not involve purchases directly from an affiliated person.

of these securities may not always constitute underwriting or selling syndicates for purposes of section 10(f)". Accordingly, it would seem axiomatic that Section 10(f) is not applicable to direct placement transactions that are conducted on an agency basis.

It has been suggested that one construction of the statutory language may be that the term "syndicate" relates only to the term "selling" and not "underwriting". This construction cannot be sustained either by plain English, by the rationale of Section 10(f) or by a reading of the authorities interpreting Section 10(f). For example, in Release 14924, the Commission regularly deletes "selling" and refers to the term "underwriting syndicate". See Release 14924, supra page 13. In one instance, the Commission reverses the order referring to a "selling or underwriting syndicate". Id. Clearly, Section 10(f) was intended to apply during the existence of an underwriting syndicate as well as a selling syndicate.

Our view of the scope of Section 10(f) also is supported fully by the legislative history of the Section. A Commission representative at the Senate hearings stated with respect to a predecessor version of Section 10(f) that the Section means "that no registered investment company shall purchase any . . . product of the [affiliated] investment banker, even though they do not buy directly . . . ." (emphasis added). See Senate Hearings at 223 (statement of L.M.C. Smith, Associate Counsel, Investment Trust Study). Likewise, Jaretzki stated in his article that Section 10(f) "limits the purchase by an investment company of securities sold or underwritten by a syndicate where affiliated persons are involved in the syndicate, even though the purchase is not made from the affiliated person." See Jaretzki, supra, page 12, at p. 319, note 50. (emphasis added)

Applying Section 10(f) to agency transactions also would not further the purposes of the Section. Congress intended the Section to address concerns about affiliated persons "dumping" securities (selling unsuitable securities to investment companies) and "bailing out" (disposing of unwanted securities by selling them to investment companies). See Report of the Securities and Exchange Commission, Investment Trusts and Investment Companies, Part Three, Chapter VII, H.R. Doc. No. 279, 76th Cong., 2d Sess. 2581, 2589 (1940). See also Senate Hearings at 212-13; Investment Trusts and Investment Companies: Hearings on H.R. 10065 Before a Subcomm. of the Comm. on Interstate and Foreign Commerce, 76th Cong., 3d Sess. 111 (1940). The incentive to engage in such activities in the context of an underwriting syndicate is much the same as the incentive for an affiliated person to sell unsuitable or unwanted securities as principal directly to an investment company. The incentive is to avoid a

risk of financial loss. Thus, Congress' purpose in enacting Section 10(f) was to close a loophole in the statutory scheme by regulating situations where underwriters could pressure affiliated investment companies to purchase underwritten securities from unaffiliated persons.

The Commission too has recognized that Section 10(f) is intended to protect against the situation where an underwriter has the incentive to in effect dump or bail out. For example, in Investment Company Act Release No. 10592 (February 13, 1979) (Rule 10f-3 proposing release), the Commission addressed the possibility of an underwriter pressuring an affiliated investment company to create an artificial market for a security, thus reducing the underwriter's risk of loss created by the position the underwriter holds in that security through its underwriting obligation. Similarly, following a public hearing held on an application filed by National Aviation Corporation for exemption from Sections 17(a) and 10(f), the Commission stated that the proposed transactions did not violate those Sections because:

The purchase [of securities] by National Aviation Corporation does not appear to have been proposed for the purpose of stimulating the market in the securities . . . or for the purpose of relieving the underwriting syndicate, or any member thereof, of securities otherwise unmarketable.

23 S.E.C. 550, 552 (1946) ("National Aviation").<sup>12</sup> Similarly, in Release 21838, the Commission discussed the purposes of Section 10(f) as guarding against the possibility that "an underwriter could . . . 'dump' unmarketable securities on its controlled fund . . . " and that fund assets might "be used to absorb the risks of any underwriting in more subtle ways, such as to facilitate price stabilization in connection with an underwriting". Release 21838, supra page 13, at text accompanying note 21.

That the incentive for the types of abuses that exist during the existence of an underwriting syndicate does not exist in the case of agency transactions is particularly evident in direct placement agency transactions. When a placement agent undertakes to place an issuer's securities on an agency basis, it neither expends nor risks its capital. Consequently, it does not own securities that it may dump on the investment company, it has no

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<sup>12</sup> The Applicant in National Aviation sought exemption from Section 10(f), as well as Section 17(a), apparently because it sought to purchase securities from unaffiliated, as well as affiliated, members of the syndicate.

working capital to free up and it has no carrying costs to avoid. A placement agent undertakes no obligation or responsibility with respect to the distribution of the security except individually to use its best efforts to find prospective buyers for the security and assist in consummating the purchase and sale. These statements are equally true whether there is only a single placement agent involved in a transaction or there are several such agents.

The limited risks and responsibilities of a placement agent are quite different from those that arise from an underwriting obligation where the affiliated person is part of a group obligated to purchase and distribute the securities. Similarly, the incentive for overreaching through dumping or bailing out is obviously not significant in an agency transaction since the most the affiliated person stands to lose is the opportunity to earn a commission that is limited to one percent.<sup>13</sup> There is no risk of loss of principal because the placement agent does not own the securities. In this regard, if Congress had been concerned about dumping or bailing out in the agency context (*i.e.*, affiliated persons pressuring investment companies to purchase so that the affiliated persons could earn commissions), Congress undoubtedly would have prohibited agency transactions in the same fashion that it did principal transactions in Section 17(a). There is no reason why Congress would have relied upon Section 10(f) to prohibit agency transactions.<sup>14</sup>

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<sup>13</sup> The one percent commission discussed above is less than the commissions that would be earned in a typical firm commitment underwriting for similar securities.

<sup>14</sup> Similarly, since Section 17(a) already prohibits principal transactions between an investment company and its affiliated persons, it would be redundant to also prohibit such transactions under Section 10(f). That is an unreasonable construction of the statute and should therefore be avoided. See Sutherland, *supra* page 12. As the Division stated in its denial of no-action relief under Section 10(f) to Cornerstone First Mortgage Bond Fund, Inc. (pub. avail. August 15, 1988) ("Cornerstone"): "An underwriter that is affiliated with an investment company is prevented by Section 17(a) from selling any security as principal to that company. The purpose of Section 10(f) . . . is, where an affiliate is a member of the syndicate, to prevent an investment company from acquiring any securities from an unaffiliated member of the syndicate . . . ." Cornerstone at note 4.

The fact that Section 10(f) is not applicable to independent dealer offerings also has been recognized implicitly in several exemptive orders granted by the Commission. Those orders permit money market funds to conduct principal transactions with affiliated persons under certain conditions.<sup>15</sup> A number of issuers, including the Federal Home Loan Mortgage Corporation, Federal National Mortgage Association, Student Loan Marketing Association and the International Bank for Reconstruction and Development, from time to time offer short-term notes on a principal basis through dealers for sale to investors at fixed prices determined by the issuer. The selling arrangements are made separately with each dealer and do not involve the existence of any underwriting or selling syndicate. The exemptive orders permit the money market funds to purchase securities from the affiliated dealer in primary fixed price dealer offerings. Each of these orders was granted pursuant to the exemptive authority contained in Sections 6(c) and 17(b), but not Section 10(f).

Finally, the contention that Section 10(f) is applicable only during the existence of an underwriting syndicate involving a group of underwriters who have combined and have joint responsibility to distribute an issue of securities is strongly supported by the no-action letter issued by the Division to Institutional Liquid Assets, supra page 14-15. Institutional Liquid Assets is a money market fund advised by Goldman, Sachs & Co. ("Goldman Sachs"). Goldman Sachs was one of six primary market broker-dealers through which short-term notes issued by Federal Home Loan Banks ("FHLB") were distributed. The FHLB notes were distributed through the primary market dealers on a principal basis with compensation consisting of a .05% dealer commission. Each dealer had independent arrangements with the FHLB and thus the various dealers had no joint responsibility as to the distribution arrangements. ILA sought no-action relief with respect to purchasing FHLB notes from the five non-affiliated primary market dealers, arguing that while Goldman Sachs was clearly a principal underwriter of the FHLB notes, Section 10(f) was not applicable because no underwriting syndicate existed and Goldman Sachs would not be benefitted by purchases from the other dealers. The Division responded favorably to the no-action request. The Division reasoned that

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<sup>15</sup> See Merrill Lynch Ready Assets Trust, et al., Investment Company Act Release Nos. 13550 (September 30, 1983) (notice) and 13598 (October 26, 1983) (order); CMA Tax-Exempt Fund, et al., Investment Company Act Release Nos. 15475 (December 11, 1986) (notice) and 15520 (January 5, 1987) (order) and Shearson Aggressive Growth Fund, Inc., et al., Investment Company Act Release Nos. 14904 (January 17, 1986) (notice) and 14948 (February 20, 1986) (order).

since Goldman Sachs had no financial commitment to purchase the FHLB notes and did not face any financial risk in effecting the transactions it should not be considered to be a member of an underwriting or selling syndicate.<sup>16</sup> See also Release 21838 at note 64.

In sum, it is respectfully submitted that purchases of securities by an investment company in direct placement agency transactions in which the company's affiliated person acts as placement agent are regulated solely and adequately by Section 17(e)(2). It is further submitted that applying Section 10(f) to such transactions is inconsistent with the express language and legislative history of Section 10(f), the statutory design of the Investment Company Act, the purposes underlying the Section, past interpretations of the Section and the industry practice that has developed.

B. Applicability of Section 206(3) to Direct Placement Agency Transactions

Section 206 of the Advisers Act contains the antifraud provisions of that statute. Subsections (1) and (2) are general antifraud prohibitions. More specific is Section 206(3), which provides, among other things, that it is unlawful for an investment adviser to knowingly sell a security to a client or purchase a security from a client unless, prior to the completion of the transaction, the adviser discloses to the client in writing the capacity in which the adviser is acting and obtains the consent of the client to the transaction. This prohibition applies to both principal and certain agency transactions.<sup>17</sup>

The 1989 letter, apparently in response to an inquiry from the Division, sought no-action relief under Section 206(3) on the basis that the boards of directors of the investment companies concerned had adopted procedures complying with substantially all

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<sup>16</sup> As noted above supra note 11, however, the Institutional Liquid Assets letter did not involve purchases from an affiliated person of the investment company.

<sup>17</sup> Specifically, Section 206(3) makes it unlawful for an investment adviser "acting as principal for his own account, knowingly to sell any security to or purchase any security from a client, or acting as broker for a person other than such client, knowingly to effect any sale or purchase of any security for the account of such client, without disclosing to such client in writing before the completion of such transaction the capacity in which he is acting and obtaining the consent of the client to such transaction."

of the requirements of Rule 206(3)-2 under the Advisers Act. Rule 206(3)-2 provides a safe harbor for compliance with Section 206(3) in the case of agency-cross transactions, provided that the conditions of the Rule are met. The 1989 letter sought the Division's concurrence with the position that under the circumstances, it was not necessary to meet paragraph (5) of the Rule. Paragraph (5) specifies that neither the investment adviser with respect to the transaction nor any person controlling, controlled by or under common control with the adviser may act as broker for both the advisory client and a person on the other side of the transaction. That is, the issue was whether, notwithstanding paragraph (5) of the Rule, the broker-dealer parent of the investment adviser could act as placement agent for issuers of the tax-exempt securities while the adviser purchased such securities for the investment companies. The Division denied that request.

We believe that the issues addressed in the 1989 letter concerning Rule 206(3)-2 are irrelevant to the instant request. Our request is that the Division confirm our view that the requirements of the Section itself are met by the common industry practice wherein the individual employed by an investment adviser to engage in portfolio management on behalf of an investment company is also an officer or otherwise an authorized person of the investment company. In such capacity, the officer or other authorized person will, as explained below, provide the consent required by the Section, obviating any need to rely on Rule 206(3)-2. Similarly, he or she will have access to such information as is contained in disclosures made pursuant to the Section.<sup>18</sup> Thus, we respectfully request that the Division confirm this interpretation or, alternatively, that the Division not recommend that the Commission take enforcement action under Section 206(3) if Merrill Lynch acts as placement agent with respect to securities purchased by the Funds, provided that the individual(s) employed by MLAM or FAM purchasing such securities for one or more of the Funds is also an officer or agent of those Funds.

Most management-type investment companies (including the Funds) are organized as corporations or Massachusetts business trusts. Such entities act through their officers or agents. In the case of portfolio management for an investment company, such an officer or agent has full authority to purchase and sell

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<sup>18</sup> The disclosure requirements normally applicable under Section 206(3) have been set forth in various Commission releases. See, e.g., Investment Advisers Act Release No. 40 (February 5, 1942); Investment Advisers Act Release No. 470 (August 20, 1975).

securities and, in so doing, effectively provide the company's consent to the purchases and sales.

In effecting portfolio transactions for an investment company, the individuals concerned must act solely in the best interests of the company. Thus, for example, if a portfolio manager or other authorized person receives payments improperly in connection with the sale of portfolio securities to the company, the investment adviser may be deemed to have committed a fraud against the company. That was the situation in Carl L. Lazzell, Investment Company Act Release No. 17808 (October 18, 1990) ("Lazzell"), in which the Commission brought an administrative proceeding under various provisions of the Federal securities laws, including Section 17(e) of the Investment Company Act and Sections 206(1) and (2) of the Advisers Act. Similarly, Section 203(f) of the Advisers Act would provide a basis for the Commission to proceed against any individuals violating their fiduciary duties to the company.<sup>19</sup> See also, Benalder Bayse, Jr., Investment Company Act Release No. T8570 (February 26, 1992). The fiduciary obligations just described are, however, different from the disclosure and consent requirements of Section 206(3). Given the dual capacity of the portfolio management personnel, the consent required by the Section will necessarily exist. In addition, imposing the disclosure requirements of Section 206(3) would be tantamount to requiring the individual to make written disclosures to himself, a strange result.<sup>20</sup>

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<sup>19</sup> Section 203(f) provides, among other things, that "the Commission, by order, shall censure or place limitations on the activities of any person associated, seeking to become associated, or, at the time of the alleged misconduct, associated or seeking to become associated with an investment adviser, . . . if the Commission finds, on the record after notice and opportunity for hearing, that such censure, placing of limitations, suspension, or bar is in the public interest and that such person has committed or omitted any act or omission enumerated [in certain specified provisions of Section 203] . . . within ten years of the commencement of the proceedings under [the] sub-section . . .

<sup>20</sup> While the above cited proceedings were silent on this point, it may be because each of the portfolio managers in those proceedings acted as agents of both the investment company and the investment adviser, that no Section 206(3) claim was included in the actions.

We note also that insofar as Section 17(e) specifically sets forth the requirements governing agency transactions between an investment company and its investment adviser or affiliated persons thereof, that Section supersedes any more general requirements applicable to investment advisers under the Advisers Act. See Sutherland, supra, page 12, at § 46.05. Similarly, it would be a peculiar result to permit the above direct placement agency transactions under Section 17(e) of the Investment Company Act but to prohibit them under Section 206(3) of the Investment Advisers Act.

### Conclusion

For the foregoing reasons we believe that Section 10(f) of the Investment Company Act is inapplicable to investment company purchases of securities in transactions where an affiliated person of the company acts as placement agent for such securities. Section 10(f) applies only in circumstances where an investment company purchases securities during the existence of an underwriting or selling syndicate of which the affiliated person is a member, but where the purchases are made from a syndicate member other than the affiliated person. Nevertheless, such purchases remain subject to the provisions of Section 17(e)(2) of the Investment Company Act and, in particular, Subsection (C) thereof. If the Division is unable to concur with our view regarding the appropriate interpretation of Section 10(f), however, we believe that the circumstances described in this letter otherwise support a favorable "no-action" response.

We further believe that the requirements of Section 206(3) are met where the employee of the investment adviser who is responsible for purchasing securities on behalf of an investment company is also an officer or agent of the investment company. In those circumstances, the consent required by Section 206(3) will by definition be given.

If you have any further questions concerning this matter please feel free to contact Thomas R. Smith, Jr. at (212) 839-5535 or Brian M. Kaplowitz at (212) 839-5370.

Very truly yours,

*Brown & Wood LLP*