24 FEB 1994

Our Ref. No. 93-523-CC
Brown & Wood
File No. 132-3

RESPONSE OF THE OFFICE OF CHIEF COUNSEL
DIVISION OF INVESTMENT MANAGEMENT

Your letter of August 17, 1993, requests our concurrence with your views on several interpretive issues concerning Rule 3a-7 under the Investment Company Act of 1940 ("1940 Act"). 1/ Specifically, you request our concurrence with the following: (1) cumulative preferred stock that has no determinable liquidation date is an "eligible asset" within the meaning of Rule 3a-7(b)(1); (2) when a structured financing program issues two or more types of securities that are not redeemable alone, but which give investors direct withdrawal rights if combined, the program does not issue redeemable securities within the meaning of Section 2(a)(32) of the 1940 Act; and (3) the term "trustee" in Rule 3a-7(a)(4) includes a custodian.

1. Is cumulative preferred stock that has no predetermined liquidation date an "eligible asset?"

Rule 3a-7(a) requires an issuer relying on the rule to be engaged in the business of purchasing, or otherwise acquiring, and holding "eligible assets." Rule 3a-7(b)(1) defines "eligible assets" as "financial assets, either fixed or revolving, that by their terms convert into cash within a finite time period plus any rights or other assets designed to assure the servicing or timely distribution of proceeds to security holders." You state that cumulative preferred stock should be considered an eligible asset even though the stock's par, stated, or liquidation value may have no predetermined payment date, and therefore the stock does not, by its terms, convert into cash within a finite period of time. 2/ You believe that, notwithstanding the absence of a self-liquidating feature, cumulative preferred stock should be considered an eligible asset because it was included in a non-exclusive list of eligible assets that appeared in subparagraph (b)(1) of proposed Rule 3a-7. 3/

In the release adopting Rule 3a-7, the Commission stated that eligible assets must be self-liquidating, and chose not to include a list of eligible assets in the final rule. 4/ The

---

1/ Rule 3a-7 excludes from the definition of "investment company" any issuer that pools certain financial assets and issues securities backed by those assets.

2/ You contrast the preferred stock with its dividends, which, you state, do convert into cash within a finite time period.

3/ Investment Company Act Rel. No. 18736 (May 29, 1992).

4/ Investment Company Act Rel. No. 19105 (Nov. 19, 1992).

Commission clearly indicated that the characteristics of a security, and not its label, are determinative. 5/ Therefore, if cumulative preferred stock has no predetermined liquidation date, it would not be an eligible asset within the meaning of Rule 3a-7(b)(1). 6/

2. Does a structured financing program that issues two or more types of securities that are not redeemable alone, but which give investors direct withdrawal rights if combined, issue redeemable securities within the meaning of Section 2(a)(32) of the 1940 Act?

Rule 3a-7(a) excepts a structured financing program from the definition of investment company if, among other things, the issuer does not issue redeemable securities. 7/ Section 2(a)(32) defines a redeemable security as "any security, . . . under the terms of which the holder, upon presentation to the issuer or a person the issuer designates, is entitled (absolutely or only out of surplus) to receive approximately its proportionate share of the issuer's current net assets or the cash equivalent."

You state that certain structured financing programs issue two classes of securities and that the holders of one class of securities ("Class B") may have the absolute or conditional right to withdraw portfolio securities from the program, upon acquisition and presentation of an appropriate amount of the other class of securities ("Class A"). Class B holders may acquire Class A securities directly (by purchasing the Class A securities) or through payment of a stipulated amount to the sponsor. 8/ You believe that, notwithstanding these direct

---

5/ *Id.* at nn.13-21 and accompanying text.

6/ This position is consistent with that of the Division of Corporation Finance. *See* Securities Act Rel. No. 6964 (Oct. 29, 1992) (adopting revisions to Form S-3).

7/ Rule 3a-7 requires structured financing programs to issue only non-redeemable securities in order to "preclud[e] [those] issuers from acting in a manner similar to mutual funds," which might lead to investor confusion between unregistered structured financings and registered investment companies. *See* Investment Company Act Rel. Nos. 19105 (adopting Rule 3a-7) at n.24 and accompanying text and 18736 (proposing Rule 3a-7) at n.61 and accompanying text.

8/ The staff understands that some issuers may conduct periodic auctions of Class A securities to enable Class B holders to acquire sufficient Class A securities to effect a withdrawal. Moreover, in some programs, Class A securities (continued...)

withdrawal rights, the structured financing program does not issue "redeemable securities." 9/

Whether a structured financing program issues redeemable securities in the circumstances you describe will depend on whether there are substantial enough restrictions on an investor's ability to withdraw portfolio securities. The Division considers the following factors to be important to this determination: (1) whether an investor's withdrawal right is conditional or absolute, 10/ (2) whether the issuer offers the matching securities for sale to investors at the same time or only at different times, (3) whether and how often the issuer sponsors activities (such as auctions and mandatory tender features) designed to facilitate an investor's ability to acquire the matching security or securities and present them for withdrawal, (4) whether the amount of portfolio securities that an investor can withdraw from the program at any one time is limited or unlimited, 11/ (5) how often an investor can withdraw

---

8/(...continued)
are subject to a mandatory tender; that is, if a Class B holder's auction bid is unsuccessful, it can require that the issuer call an appropriate amount of Class A securities. The Class B holder, upon payment of the face amount of the called Class A securities, then may present both securities to the issuer to effect the withdrawal.

9/ You also state that the structured financing program does not issue redeemable securities even if the Class A and Class B securities, once combined, are viewed as redeemable. Because the decision to combine is the investor's and is not dictated by the terms of the offering, you do not believe that the program is the "issuer" of the combined security. We disagree. Although the decision to combine is the investor's, the structured financing program will define all of the rights attributable to the Class A and Class B securities, and will register the securities under the Securities Act of 1933. Further, the program, not the investor, is the obligor of the recombined security. *See* The SuperTrust Trust for Capital Market Fund, Inc. Shares, Investment Company Act Rel. No. 17613 (Jul. 25, 1990) (unit investment trust was issuer of redeemable security as well as its non-redeemable components).

10/ *See* United States Property Investments, N.V. (pub. avail. May 1, 1989) (no obligation on part of issuer to redeem any or all of the securities tendered).

11/ In an effort to distinguish closed-end interval funds from issuers of redeemable securities, the Commission limits the (continued...)

portfolio securities from the program, 12/ (6) whether or not there is a holding period requirement, 13/ (7) the denomination of the securities and the minimum amount needed to withdraw portfolio securities, 14/ and (8) how the withdrawal right feature is presented to investors.

Your letter does not contain sufficiently specific facts about the structured financing programs and the withdrawal rights to enable the staff to determine whether or not the programs should be deemed to be issuing redeemable securities. Therefore, we cannot concur in your opinion that these arrangements would not cause Rule 3a-7 to be unavailable.

3. Does the term "trustee" in Rule 3a-7(a)(4) include a custodian?

Rule 3a-7(a)(4) requires an issuer relying on the rule to appoint a trustee that meets the requirements of Section 26(a)(1) of the 1940 Act. Section 26(a)(1) requires the trustee or custodian of a unit investment trust to be a bank with aggregate capital, surplus, and undivided profits of at least $500,000.

11/(...continued)
size of repurchase offers by closed-end management investment companies to not more than 25% of the company's outstanding common stock. *See* Rule 23c-3(a)(3) and Investment Company Act Rel. Nos. 18869 (Jul. 28, 1992) (proposing Rule 23c-3) and 19399 (Apr. 7, 1993) (adopting Rule 23c-3). *See also* California Dentists' Guild Real Estate Mortgage Fund II (pub. avail. Jan. 4, 1990) (withdrawals limited to the lesser of $100,000 or 25% of the investor's account per quarter); Redwood Mortgage Investors VII (pub. avail. Jan. 5, 1990) (total withdrawals limited to 20% of outstanding accounts per year).

12/ *See, e.g.*, California Dentists' Guild Real Estate Mortgage Fund II (quarterly withdrawals with 90 days' notice required); Redwood Mortgage Investors VII (quarterly withdrawals with three months' notice required); United States Property Investments, N.V. (annual withdrawals with four months' notice required).

13/ *See, e.g.*, California Dentists' Guild Real Estate Mortgage Fund II (one year holding period); Redwood Mortgage Investors VII (one year holding period); United States Property Investments, N.V. (two year holding period).

14/ *See* SPDR Trust, Series 1, Investment Company Act Rel. No. 18959 (Sept. 17, 1992) (substantial dollar amount required to aggregate non-redeemable securities into redeemable unit).

You state that Section 26(a)(1) expressly contemplates the use of a custodian bank, and that many structured financing programs use custodians rather than trustees. You also state that the Commission, in proposing and adopting the rule, never expressly precluded the use of a custodian bank. Finally, you state that a custodian bank is able to perform the same functions and comply with the same requirements required of a trustee bank.

Rule 3a-7(a)(4) specifically requires an issuer to appoint a trustee. Therefore, we cannot concur in your opinion that the term "trustee" in Rule 3a-7(a)(4) includes a custodian.

Monica L. Parry
Senior Counsel

555 CALIFORNIA STREET
SAN FRANCISCO, CA. 94104-1715
TELEPHONE: 415-398-3909
FACSIMILE: 415-397-4621

10900 WILSHIRE BOULEVARD
LOS ANGELES, CA. 90024-3959
TELEPHONE: 310-443-0200
FACSIMILE: 310-208-5740

SHIROYAMA JT MORI BUILDING, 15TH FLOOR
3-1, TORANOMON 4-CHOME, MINATO-KU
TOKYO 105, JAPAN
TELEPHONE: 03-5472-5360
FACSIMILE: 03-5472-5058

BROWN & WOOD

ONE WORLD TRADE CENTER
NEW YORK, N.Y. 10048-0557
TELEPHONE: 212-839-5300
FACSIMILE: 212-839-5599

815 CONNECTICUT AVENUE, N.W.
WASHINGTON, D.C. 20006-4004
TELEPHONE: 202-973-0600
FACSIMILE: 202-223-0485

172 WEST STATE STREET
TRENTON, N.J. 08608-1104
TELEPHONE: 609-393-0303
FACSIMILE: 609-393-1990

BLACKWELL HOUSE
GUILDHALL YARD
LONDON EC2V 5AB
TELEPHONE: 071-606-1888
FACSIMILE: 071-796-1807

ACT 1940 ICA
SECTION
RULE 3a-7
PUBLIC AVAILABILITY 2/24/94

Investment Company Act of 1940
Rule 3a-7

August 17, 1993

Division of Investment Management
Securities and Exchange Commission
Washington, D.C. 20549

Attention: Office of Chief Counsel

Ladies and Gentlemen:

Reference is made to Investment Company Act Release No. IC-19105, dated November 19, 1992 (the "Release"), relating to the adoption of Rule 3a-7 (the "Rule") under the Investment Company Act of 1940 (the "Act"). The Rule, which provides that structured financing arrangements meeting certain requirements are not subject to registration under the Act, is designed to remove "an unnecessary and unintended barrier to the use of structured financings." We believe that this goal has been substantially achieved; however, as with any important initiative, certain technical issues are presented by the language of the Rule in its final form. We have been requested to give advice respecting the application of the Rule to certain structured financing arrangements which appear to fall within the intent of the Rule but are not clearly reconcilable to its actual text. Based upon informal conversations with certain staff members, we understand that resolution of these issues should be pursued through the no-action letter process. Accordingly, the purpose of this letter is to request that the staff recommend that the Commission take no enforcement action if transactions are effected based on our view as to the proper resolution of the following issues. Terms used but not defined in this letter have the meanings assigned to them in the Release.

1. Is cumulative preferred stock an "eligible asset"? The form of proposed Rule 3a-7 as set forth in Investment Company Act Release No. 18736, dated May 29, 1992 (the "Proposing Release"), contained a non-exclusive list of eligible assets (defined in the proposed rule to mean "obligations that require scheduled cash payments") which included "cumulative preferred stock." The Rule, however, requires that eligible assets "by their terms convert into cash within a finite time period". This definition clearly encompasses the dividends payable on cumulative preferred stock, which can be valued, statistically analyzed and securitized. However, the par, stated or liquidation value of a share of cumulative preferred stock may have no determinable payment date and it would not, therefore, appear to be a "self-liquidating" asset. Because the Release states that the definition of eligible assets "is intended to include all of the assets provided as examples in the proposed paragraph" and does not otherwise indicate an intent to exclude cumulative preferred stock, we believe that the term "eligible assets" should be understood to include cumulative preferred stock.

2. Do certain types of withdrawal rights create redeemable securities? A number of structured financings involve the deposit of securities with a non-affiliated bank, acting as depositary or custodian,[1] and the issuance by the bank of receipts evidencing interests in the eligible assets so deposited. For example, if fixed rate securities are deposited, one class of receipt ("Class A Receipts") may entitle the holder to distributions at a floating or adjustable rate, with the residual class of receipt ("Class B Receipts") receiving any remaining cash flow. In many cases, however, a holder of the Class B Receipts may have the absolute or conditional right to withdraw deposited securities, upon acquisition and presentation of an appropriate amount of the Class A Receipts (which acquisition may be effected directly or through payment of a stipulated amount which is then distributed to effect retirement of the related Class A Receipts). We believe that these direct withdrawal rights do not constitute the issuance of "redeemable securities" as prohibited by Rule 3a-7.

The Commission stated in the Proposing Release that Rule 3a-7 would be unavailable to structured financings issuing redeemable securities in order to preclude such "issuers from acting in a manner similar to registered investment companies." The Rule's prohibition on the issuance of redeemable securities is based on the same concern that led Congress in 1970 to incorporate a virtually identical prohibition for entities seeking to rely on the exception from the Act set forth in

---

[1] See question 3 below.

Section 3(c)(5) thereof. See Report of the Securities and Exchange Commission on the Public Policy Implications of Investment Company Growth, H.R. Rep. No. 2337, 89th Cong., 2d Sess. 328-9 (1966). See also S. Rep. No. 184, 91st Cong., 1st Sess. 37 (1969); H.R. Rep. No. 1382, 91st Cong., 2d Sess. 17 (1970). Accordingly, the Release instructs counsel to look to Commission staff no-action letters under Section 3(c)(5) for guidance on whether particular types of securities may be considered redeemable.

We do not believe the withdrawal rights discussed above are redeemable securities either under the literal wording of the Act's definition of a "redeemable security" or under staff no-action letters. Under Section 2(a)(32) of the Act, a redeemable security is defined as:

> any security, other than short term paper, under the terms of which the holder, upon its presentation to the issuer or to a person designated by the issuer, is entitled (whether absolutely or only out of surplus) to receive approximately his proportionate share of the issuer's current net assets, or the cash equivalent thereof.

We recognize that Section 2(a)(32) encompasses redemptions in kind (i.e., redemptions for securities held by the issuer) as well as redemptions for cash, and that the right to withdraw deposited securities may at first appear similar to a redemption in kind. Upon closer examination, however, it is apparent that those withdrawal rights fall outside the Section. Neither the Class A Receipt holders nor the Class B Receipt holders have the right to require withdrawal upon mere presentation of a Receipt to the issuer. A Class A Receipt holder has no withdrawal right at all. Moreover, a Class B Receipt holder may exercise its withdrawal right only if such holder first acquires Class A Receipts (either directly or by making payment of an amount sufficient to retire a stipulated principal amount of Class A Receipts). Thus, there is no unencumbered right to redeem within the meaning of the Section.

In addition, the amount of securities withdrawn do not correspond to a "proportionate share of the issuer's current net assets" under the Section. That is, the withdrawal rights attached to Class B Receipts require the presentation or retirement of a stipulated amount of Class A Receipts; the Class B Receipt holder does not, in effect, realize fully the value of the withdrawn securities.

The actions required of a Class B Receipt holder in order to withdraw deposited securities also constitute "substantial restrictions" on the right to redeem in accordance with prior

Commission staff no-action letters under Section 3(c)(5). As recognized in the Release, where such restrictions exist with respect to a security, the security should not be considered redeemable so as to render the issuer ineligible to rely on the Rule.

We are unaware of any no-action letters precisely on point. However, certain principles evidenced in the letters support the conclusion that the conditions to withdrawal of deposited securities constitute "substantial restrictions." The staff has found substantial restrictions to exist where there are restrictions on either the amount or frequency of redemptions, or both. See, e.g., California Dentists' Guild Real Estate Mortgage Fund II (pub. avail. January 4, 1990) (security redeemable only at quarterly intervals commencing one year after purchase, then up to a maximum of $100,000 or 25% of the investor's account); Redwood Mortgage Investors VII (pub. avail. January 5, 1990) (one year holding period and quarterly redemptions of limited amount); United States Property Investment, NV (pub. avail. May 1, 1989) (initial two year holding period requirement). The withdrawal rights at issue here impose similar types of restrictions on the withdrawal of deposited securities. A Class B Receipt holder cannot simply present such Receipt for withdrawal; a Class B Receipt holder must expend funds to realize the value of such securities. Specifically, such Class B Receipt holder must either undertake the expense of acquiring the necessary amount of Class A Receipts in the secondary market or pay the stipulated amount before being permitted to withdraw the deposited securities. We believe these restrictions are substantial and readily distinguish these withdrawal rights from the types of freely redeemable securities issued by registered open-end investment companies.[2]

Finally, we believe that even if the Class A Receipts and Class B Receipts, once recombined by the Class B Receiptholder, may be viewed as redeemable, the arrangement still would not violate Rule 3a-7. The Rule is available to a structured financing provided that the financing does not issue redeemable securities. In accordance with that requirement, the structured financings involved in our request never issue any security that by itself is redeemable; a purchaser of Class B Receipts may also choose initially to purchase Class A Receipts, but that is a

---

[2] It is true that registered open-end investment companies may charge redemption fees of up to two percent of the amount redeemed to cover certain costs. Such charges, obviously, are at a lower level and for very different purposes than the types of expenses which must be incurred in connection with the withdrawal rights.

decision made by the buyer, and not dictated by the terms of the offering.

3. Will a "custodian" bank satisfy paragraph (a)(4)? We note that the Rule requires the use of a trustee bank meeting the requirements of Section 26(a)(1) of the Act. That section expressly contemplates the use of a "custodian" bank. For reasons of precedent and custom, many structured financings involving the deposit of securities use arrangements and terminology customary for custody rather than trustee relationships. Assuming the other requirements of Section 26(a)(1) are met, we believe that the term trustee in paragraph (a)(4) of the Rule should include a custodian and we request your concurrence in this view. In support of our request we note that neither the Proposing Release nor the Release reflect any intention on the part of the Commission to preclude the use of a custodian, rather than a technical trustee. To the contrary, footnote 93 of the Proposing Release recognizes that a similar incorporation by reference of Section 26(a)(1) of the Act exists in Section 17(f) of the Act, which governs the qualifications of banks that may serve as custodians for registered investment companies.[3] In addition, as noted above, Section 26 itself accommodates both trust and custodianship arrangements. Similarly, Section 4(2) of the Act defines a unit investment trust as an investment company which, among other things, "(A) is organized under a trust indenture, contract of custodianship or agency, or similar instrument. . ." (emphasis added). Finally, there is no regulatory purpose to be served by requiring a trustee rather than a custodian. An independent custodian can perform the same functions and meet the same requirements required of a trustee by paragraph (a)(4) of the Rule. It is those requirements that are important, not the particular form of arrangement used.

In accordance with your request, this letter is intended to restate our prior letter to the Division of Investment Management dated March 9, 1993.

---

[3] Section 17(f) provides that "[e]very management investment company shall place and maintain its securities and similar investments in the custody of (1) a bank or banks having the qualifications prescribed in [Section 26(a)(1)] for the trustees of unit investment trusts."

Should you require any clarification or further information concerning these issues, please do not hesitate to call the undersigned (212-839-5354) or Brian M. Kaplowitz (212-839-5370) of this office.

Very truly yours,

Kenneth T. Cote

cc: Thomas S. Harman
Monica L. Parry