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RESPONSE OF THE OFFICE OF CHIEF COUNSEL
DIVISION OF INVESTMENT MANAGEMENT

Our Ref. No. 95-266-CC
Mutual Series Fund Inc.
File No. 811-5387

Your letter dated May 8, 1995 requests our concurrence that each series of a registered open-end series investment company should be considered a separate investment company in applying the restrictions set out in Section 12(d)(1)(A) of the Investment Company Act of 1940 ("1940 Act"). You have requested the staff's views so that each of the four series comprising Mutual Series Fund Inc. (the "Fund") 1/ may purchase shares of closed-end investment companies and apply those restrictions on a series-by-series basis.

Section 12(d)(1)(A) generally prohibits a registered investment company from: (1) purchasing more than 3% of the outstanding voting shares of another investment company; (2) investing more than 5% of its total assets in the shares of another investment company; and (3) investing more than 10% of its total assets in the shares of other investment companies. These restrictions were intended to address certain perceived abuses that could result from a fund holding company structure, often referred to as a "fund of funds" structure. 2/ Under the express language of Section 12(d)(1)(A), the Section's investment restrictions apply to individual investment companies. By its terms, Section 12(d)(1)(A) does not require the investments of

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1/ The series of the Fund are Mutual Beacon Fund, Mutual Qualified Fund, Mutual Shares Fund and Mutual Discovery Fund.

2/ The following abuses have been cited in the legislative history of Section 12(d)(1)(A) and in other sources: (1) the acquisition of voting control by one investment company over another investment company; (2) undue influence over the portfolio management of the acquired company through the threat of large scale redemptions and loss of advisory fees to the adviser, and the disruption of the orderly management of the company through the maintenance of large cash balances to meet potential redemptions; (3) the difficulty on the part of an unsophisticated shareholder of the acquiring fund in appraising the true value of his security; and (4) the layering of sales charges, advisory fees, and administrative costs. See The Phoenix Funds (pub. avail. Oct. 2, 1991) (citing H.R. Rep. No. 1382, 91st Cong., 2d Sess. 2-3, 10-11 (1970)); Public Policy Implications of Investment Company Growth, reprinted in H.R. Rep. No. 2337, 89th Cong., 2d Sess. 314-24 (1966).

one registered investment company to be aggregated with the investments of any other registered investment company, including another investment company in the same fund complex or advised by the same investment adviser or manager. 3/

Each series of a series investment company typically operates, for investment purposes, as a separate investment company. 4/ The Commission, through certain exemptive rules, and the staff, in various no-action and interpretive positions, have recognized that a series is the functional equivalent of a separate investment company and have concluded that an individual series should be deemed a separate investment company in applying the various limitations and restrictions imposed by the 1940 Act and the rules under the 1940 Act. 5/ In light of our conclusion

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3/ That Congress intended the provisions of Section 12(d)(1)(A) to be applied individually to related investment companies is strongly supported by comparing its terms to those of Section 12(d)(1)(C) of the 1940 Act. Section 12(d)(1)(C) prohibits an investment company, and any other investment companies having the same investment adviser, from purchasing more than 10% of the voting securities of a particular closed-end investment company. Section 12(d)(1)(C), in contrast to Section 12(d)(1)(A), addresses potential abuses associated with the aggregate acquisition of a closed-end investment company's shares by funds that have a common investment adviser.

4/ See Joseph R. Fleming, *Regulation of Series Investment Companies Under the Investment Company Act of 1940*, 44 Bus. Law. 1179, 1180 (1989).

5/ See Rules 12d3-1(d)(8) and 17a-7 under the 1940 Act; Fundtrust (pub. avail. Jan. 7, 1986) (Section 12(d)(1)(F)); Municipal Bond Trust Series (pub. avail. Apr. 22, 1979) (Section 12(d)(1)(A)); Cardinal Tax-Exempt Bond Fund (pub. avail. Mar. 14, 1977) (Section 12(d)(1)(A)); Salomon Brothers Inc. (pub. avail. May 26, 1995) (Sections 2(a)(3) and 17(a)); The One Group (pub. avail. May 23, 1995) (Section 10(f)); Scudder Investment Trust (pub. avail. Mar. 23, 1994) (Form N-SAR); PaineWebber Series Trust (pub. avail. Dec. 14, 1987) (Section 5(b)(1)).

To date, the staff has identified only one exception to its position that series companies should be treated as separate investment companies. The staff recently took the position that the assets of a series investment company may be aggregated for purposes of calculating the amount of the fidelity bond required by Rule 17g-1 under the 1940 Act. Letter to Paul Schott Stevens, General Counsel, Investment Company Institute, from Jack W. Murphy, Associate Director (Chief Counsel), Division of Investment Management, Securities and Exchange Commission (Apr. 12, 1995). The staff is currently considering whether to that Congress intended the provisions of Section 12(d)(1)(A) to be applied individually to related investment companies, and our view that an individual series of a series investment company should generally be treated as a separate investment company, we believe that each series should be considered a separate investment company in applying the limitations set out in Section 12(d)(1)(A).

Accordingly, the four series of the Fund may acquire shares of closed-end investment companies provided that each series individually complies with the limitations of Section 12(d)(1)(A).

Amy R. Doberman
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Assistant Chief Counsel

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recommend that the Commission propose amendments to Rule 17g-1 that would, among other matters, clarify the rule's application to series companies.

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May 8, 1995

Investment Company Act of 1940
Section 12(d)(1)

BY FEDERAL EXPRESS

Jack W. Murphy, Esq.
Associate Director and Chief Counsel
Division of Investment Management
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

Act	IA of 1940
Section	12(d)(1)(A)
Rule	
Public Availability	11/7/95

Re: Mutual Series Fund Inc.

Dear Mr. Murphy:

We are writing on behalf of our client, Mutual Series Fund Inc. ("Mutual Series"), a registered investment company, and its four series funds, Mutual Beacon Fund ("Beacon"), Mutual Qualified Fund ("Qualified"), Mutual Shares Fund ("Shares), and Mutual Discovery Fund ("Discovery").[1] We request the concurrence of the staff of the Securities and Exchange Commission ("SEC") with our opinion that the limitations imposed by Section 12(d)(1)(A) of the Investment Company Act of 1940, as amended ("Investment Company Act"), on the ownership by one investment company of the shares of another investment company can be applied on a series-by-series basis, and not on the basis of the Mutual Series's aggregate holdings.

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1 Mutual Series is an open-end, diversified, management investment company managed by Heine Securities Corp. ("Heine"), a registered investment adviser.

LEGAL ANALYSIS

I. Section 12(d)(1)(A) of the Investment Company Act

A. The Proposed Investments

Certain closed-end investment companies offer unique and highly attractive investment opportunities.[2] For example, in many foreign markets, it is difficult, and sometimes even impossible, for United States investors to purchase securities of the home country. In such circumstances, purchases of the shares of a closed-end country fund may be the only, or the most cost effective, way for investment companies to invest in certain foreign securities. Since many foreign securities can represent attractive investment opportunities, investment in these securities through the purchase of shares of a closed-end country fund can be beneficial to investment company shareholders.

Given the benefits of investing in closed-end funds, each series of an investment company organized as series portfolios may seek to acquire up to three percent of the outstanding securities of such closed-end funds. However, because Section 12(d)(1)(A) literally applies to "any registered investment company," it is arguable that the aggregate holdings of all of the series of an investment company would be limited to three percent of the outstanding securities of the closed-end funds being acquired. In contrast, separately registered investment companies sharing the same investment adviser clearly could each acquire up to the three percent limit.

B. The Fund of Funds Restriction and Its Purpose

Section 12(d)(1) of the Investment Company Act is commonly referred to as the restriction on a "fund of funds." This provision restricts, but does not prohibit, purchases by one investment company of the shares of another investment company.[3] In general, the provision restricts an investment company's purchases of

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2 This no-action request is limited to investments by open-end funds in the shares of closed-end funds. Open-end funds generally do not invest in other open-end funds, except to invest idle cash in money market funds.

3 Section 12(d)(1)(A) provides that:

(continued...)

the shares of another investment company in three ways:

1. An investment company cannot buy more than three percent of the shares of another investment company;

2. An investment company cannot invest more than five percent of its total assets in the shares of another investment company; and

3. An investment company cannot invest more than ten percent of its total assets in the shares of other investment companies.

This provision was contained in the original Investment Company Act, enacted in 1940, and was expanded somewhat to apply to unregistered investment companies

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[3](...continued)

> It shall be unlawful for any registered investment company (the "acquiring company") and any company controlled by such acquiring company to purchase or otherwise acquire any security issued by any other investment company (the "acquired company"), and for any investment company (the "acquiring company") and any company or companies controlled by such acquiring company to purchase or otherwise acquire any security issued by any registered investment company (the "acquired company"), if the acquiring company and any company or companies controlled by it immediately after such purchase or acquisition own in the aggregate --
>
> (i) more than 3 per centum of the total outstanding voting stock of the acquired company;
>
> (ii) securities issued by the acquired company having an aggregate value in excess of 5 per centum of the value of the total assets of the acquiring company; or
>
> (iii) securities issued by the acquired company and all other investment companies (other than treasury stock of the acquiring company) having an aggregate value in excess of 10 per centum of the value of the total assets of the acquiring company.

when Congress amended the Investment Company Act in 1970. During deliberations on both the 1940 statute and the 1970 amendment, the SEC recommended that a flat prohibition be enacted preventing one investment company from owning the shares of another investment company.[4] In each case, Congress rejected the SEC's recommendation because "a complete prohibition may preclude investment companies from taking advantage of good business opportunities."[5] Accordingly, Section 12(d)(1), as originally adopted and subsequently amended, imposes restrictions on the ownership by one investment company of the shares of another investment company, but does not prohibit such ownership.

The SEC staff has identified four potential abuses which Section 12(d)(1) is designed to limit:

- the acquisition of voting control of the investment company;

- undue influence over portfolio management through the "threat of large scale redemptions" and "loss of advisory fees" to the adviser, and the disruption of the orderly management of the investment company through the maintenance of large cash balances to meet potential redemptions;

- the complexity of the structure with the resultant difficulty on the part of the uninitiated shareholder in appraising the true value of his security; and

- the layering of sales charges, advisory fees, and administrative costs.[6]

These same policy considerations were identified by a prominent commentator on the Investment Company Act as the reasons for the enactment of Section 12(d)(1):

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4 See 3 Frankel, The Regulation of Money Managers 238, 240 (1978); S. 3580, 76th Cong., 3d Sess. §12(c)(1))(1940), 1940 Senate Hearings at 237-39; SEC, Report on the Public Policy Implications of Investment Company Growth, H.R. Rep. No. 2337, 89th Cong., 2d Sess. 323 (1966).

5 3 Frankel, The Regulation of Money Managers 238-39, 241 (1978).

6 The Phoenix Fund, SEC No-Action Letter (pub. avail. October 28, 1991).

> In its pre-1940 study, the SEC found that investment companies' pyramiding, by investing in securities of other investment companies, had undesirable results. These investments produced undue concentration of control without commensurate commitment of capital, and duplication of advisory fees, administrative fees, and sales loads. . . . . [In addition, t]he existence of an investment company holding company as a substantial shareholder may subvert the investment policies of the subsidiary open-end investment company; the open-end investment company may have to leave a high percentage of its assets in liquid form to meet a substantial redemption demand.[7]

Thus, Section 12(d)(1) reflects a delicate Congressional balancing of two competing policy considerations. On the one hand, a "fund of funds" can be unduly expensive for fund shareholders and disruptive of the corporate governance structure of the acquired fund. On the other hand, the shares of another investment company may be an attractive investment opportunity for an investment company and its shareholders.

C. Application of Section 12(d)(1) to Series Funds

The SEC staff has never directly addressed the question, for open-end funds, of whether the limitations imposed by Section 12(d)(1) on the ownership by one investment company of the shares of another investment company should be applied on a series-by-series basis, or should be applied to the entire complex of funds (i.e., the registered investment company comprised of the various series) in the aggregate.[8] Each of the three restrictions has a potentially different application depending on whether the test is applied to each fund in a series or to the complex as a whole.

1. Practical Implications of the Different Interpretations of Section 12(d)(1)

One of the three tests, the three percent test, would have a more restrictive interpretation if applied to the complex (i.e., the registered investment company comprised of the various series) as a whole, rather than to each series portfolio of the

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7 3 Frankel, The Regulation of Money Managers 238-39 (1978).

8 As noted below, the SEC staff has applied Section 12(d)(1) on a series-by-series basis to unit investment trusts.

investment company. To illustrate this, if each series portfolio is limited to purchasing no more than three percent of the shares of another investment company, but such a limitation is not imposed on the complex as a whole, the complex could acquire more than three percent of the shares of another investment company. This would occur, for example, if more than one series portfolio in the complex acquired three percent of the outstanding shares of another investment company.

The other two tests would have a more restrictive interpretation if applied on a series-by-series basis, rather on a complex-wide basis. First, if the complex as a whole is limited to investing no more than five percent of its assets in the securities of another investment company, but each series portfolio in the complex is not so limited, a series portfolio could invest more than five percent of its assets in another investment company without the complex exceeding the five percent limitation. Indeed, it is possible, depending on the facts, that a series portfolio could invest all of its assets in the shares of another investment company without the complex exceeding the five percent limitation. Second, if the complex as a whole is limited to investing no more than ten percent of its total assets in the shares of other investment companies, but each series portfolio is not so limited, it is possible that a particular series portfolio could invest all of its assets in the shares of other investment companies without causing the complex to exceed the ten percent limitation in the aggregate.

2. Relevant Prior No-Action Letters

As one commentator has noted, "[w]ith a few notable exceptions, the . . . SEC and its staff have applied the provisions of the Investment Company Act . . . to a series fund as if the individual portfolios of that fund were separate investment companies."[9] Consistent with this approach, in one no-action letter, the SEC staff

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[9] Joseph B. Fleming, Regulation of Series Investment Companies Under the Investment Company Act of 1940, 44 Bus. Law. 1179, 1180 (1989).

This commentator argues that "it might be appropriate to apply both the three- and five-percent limitations in section 12(d)(1)(A) to the assets of a series company as a whole. . . [but that] application of the ten-percent test on a series-by-series basis seems warranted." Id. at 1201. These conclusions are based on two erroneous premises. First, the author's argument that the five percent asset test would have a more restrictive interpretation if applied on a complex-wide basis, rather than on a series-by-series basis, is simply wrong.

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applied Section 12(d)(1)(F) of the Investment Company Act, which creates an exemption from the restrictions imposed by Section 12(d)(1)(A), on a series-by-series basis.[10]

Section 12(d)(1)(F) permits purchases of another investment company's shares in excess of the limitations imposed by Section 12(d)(1)(A), provided that, among other things, the purchasing investment company does not sell its shares with a sales load exceeding one and one half percent. In Fund Trust, the SEC permitted certain series portfolios in a complex to rely on Section 12(d)(1)(F) even though other series portfolios in the complex intended to offer their shares with sales loads in excess of one and one half percent. This no-action letter reflects an application of the exception created by Section 12(d)(1)(F) on a series-by-series basis rather than on a complex-wide basis.

The SEC staff has also applied Section 12(d)(1)(A) on a series-by-series basis to unit investment trusts.[11] In these no-action letters, the SEC staff has treated each series of a unit investment trust as a separate investment company for purposes of

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[9](...continued)

(The author erroneously argues that "an acquiring company with multiple series could control another investment company without violating section 12(d)(1)(A)'s limitation on the acquiring company not investing more than five percent of its assets in another investment company, assuming a series-by-series test for compliance with that section." Id. at 1201.) In fact, the more expansive interpretation of Section 12(d)(1)(A) would apply the five percent asset test on a series-by-series basis.

Second, the author makes the erroneous policy argument that Section 12(d)(1) was enacted to remedy certain abuses and, therefore, that the provision should be interpreted as broadly as possible to minimize those abuses. This analysis completely ignores the fact that Section 12(d)(1) reflects a Congressional balancing of the benefits of fund ownership of other funds against the problems created by such ownership. It is by no means clear that this balance is best struck through the most expansive possible reading of Section 12(d)(1).

10 Fund Trust, SEC No-Action Letter (pub. avail. Feb. 6, 1986).

11 Cardinal Tax-Exempt Bond Fund, (pub. avail. March 14, 1977), reprinted in, [1986-87 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶81,008; Municipal Bond Trust Series, SEC No-Action Letter (pub. avail. April 22, 1979).

calculating the percentage limitations imposed by Section 12(d)(1)(A).[12]

These no-action letters reflect the logical and sound policy of applying Section 12(d)(1)(A) on a series-by-series basis. If an investment company complex were organized as several separately registered investment companies, rather than as series portfolios, there would be no question that Section 12(d)(1)(A) would be applied separately to each investment company in the complex. There is no reason why a different rule should apply simply because the complex organizes itself as series portfolios rather than as separate investment companies.

D. Section 12(d)(1) Should Be Applied on a Series-by-Series Basis

The three tests in Section 12(d)(1) should be applied separately to each series in a complex, rather than being applied to the complex as a whole. Such an interpretation better serves the purposes of Section 12(d)(1) without unduly depriving open-end funds of valuable investment opportunities. In addition, any other interpretation would illogically differentiate between series portfolios and separate investment companies managed by the same adviser.

First, application of the three tests set forth in Section 12(d)(1) on a series-by-series basis best protects against the abuses of a fund of funds structure. If the ten percent and five percent asset tests were applied to the complex as a whole, an individual series in the complex could invest all of its assets in the shares of another investment company. This result would be prevented by applying these tests on a series-by-series basis.

More important, application of the three tests on a series-by-series basis would further the policy considerations underlying Section 12(d)(1). This interpretation would permit series portfolios to take advantage of valuable investment opportunities offered by certain closed-end funds. In addition, the disadvantages created by a fund of funds structure would be minimal because only shares of closed-end funds would be purchased. For example, there would be minimal interference with the governance

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12 One commentator has argued that "[t]wo important factors distinguish unit investment trusts from mutual funds: Unit investment trusts are unmanaged portfolios without a corporate-type management structure and units of each series are typically traded in the secondary market, rather than redeemed by the series trust. These factors tend to allay some of the concerns Congress attempted to address in §12(d)(1)." Fleming, supra, at 1202, n. 126.

of the closed-end funds since the four Mutual Series portfolios would never own a controlling interest in any closed-end fund.[13] Redemption requests by the Mutual Series funds would not be a concern, since closed-end funds do not redeem their shares. Finally, ownership of any closed-end fund's shares should be sufficiently dispersed to protect against undue dominance of the closed-end fund's board.

In addition, the disadvantage to the acquiring fund's shareholders of layering advisory and other fees would be offset by investment opportunities the closed-end funds would offer which would not otherwise be easily available to the acquiring fund. Furthermore, these investments would never exceed five percent of the assets of any one series if all three of the tests under Section 12(d)(1) were applied to each series. Finally, the fund structure should not be unduly complex or difficult for shareholders to understand. The shares of a closed-end fund are purchased and sold on secondary markets like any other securities. The shareholders of Mutual Series should have no trouble understanding such investments.

CONCLUSION

For the reasons set forth above, we respectfully request your concurrence with our opinion that the limitations imposed by Section 12(d)(1)(A) of the Investment Company Act on the ownership by one investment company of the shares of another investment company can be applied on a series-by-series basis, and not on the basis of the complex of series funds viewed as a whole.

In accordance with Securities Act Release No. 33-5127 (Jan. 25, 1971), we

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13 Under Section 12(d)(1)(C) of the Investment Company Act, investment companies managed by the same adviser cannot acquire, in the aggregate, more than ten percent of the shares of a closed-end investment company:

> It shall be unlawful for any investment company (the "acquiring company") and any company or companies controlled by the acquiring company to purchase or otherwise acquire any security issued by a registered closed-end investment company, if immediately after such purchase or acquisition the acquiring company, other investment companies having the same investment adviser, and companies controlled by such investment companies, own more than 10 per centum of the total outstanding voting stock of such closed-end company.

hereby submit an original and one copy of this letter (including one copy for each subsection of Sections 12(d)(1) for which relief is requested). Kindly indicate receipt by date stamping the copy marked "Stamp Copy" and returning it to me.

Should you have any questions regarded this request, please telephone me at (212) 536-3941.

Very truly yours,

Richard D. Marshall

Richard D. Marshall

cc: Barbara Chretien-Dar, Esq.
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