INSIDER TRANSACTIONS UNDER THE 1940 ACT

The Sweeping Prohibition of Section 17 of the Investment Company Act Can Be Relaxed by the SEC Through Its Power to Exempt Transactions Found to be Fair to All Parties

By Tamar Frankel

Congressional hearings in 1940 revealed that investment companies were often managed for the benefit of their directors, investment advisors, and underwriters, not for the benefit of the shareholders. Insiders sold to their investment companies worthless stock, bought property from them at less than the market price, and borrowed money on terms less than customary collaterals. Insiders sold control of the companies to persons who looted them to pay the purchase price.

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1. Hearings on S.1050 Before a Subcommittee of the Senate Comm. on Banking and Currency, 76th Cong., 2d Sess., pt. 3, 37-38, 66, 101 (1940) ["1940 Senate Hearings"]; Hearings on H.R. 10055 Before the Subcommittee of the House Comm. on Interstate and Foreign Commerce, 76th Cong., 2d Sess., pt. 3, 43 (1940) ["1940 House Hearings"] (statement of Cassinapple Robert F. Healy); 1940 Act, §17(b)(2) (the national public interest and the interests of investors are afforded adequate "when the investment companies are operated, managed, or their portfolios managed, in the interest of tenants, officers, investment advisors, dealers, or other affiliated persons thereof, in the interest of underwriters, brokers, or dealers, in the interests of special classes of security holders, or in the interest of other investment companies or persons engaged in other lines of business, rather than in the interest of all classes of such company or security holders.")

2. 1940 Senate Hearings at 106.

3. Id. at 208. For examples of abuses, see below the Act not id. at 64-65.


5. (a) It shall be unlawful for any affiliated person or promoter of or principal underwriter for a registered investment company (other than a company of the character described in section 12(b)(3)(A) and (B) of this title), or any affiliated person of such a person, promoter, or principal underwriter, acting as principal—

(1) knowingly to sell any other property to such registered company or to any company controlled by such registered company, unless such sale involves—

(A) an investment of which the buyer is the issuer, (B) an investment of which the seller is the issuer and which are part of a general offering to the holders of a class of its securities, or (C) securities dealing with the treasuries of a unit investment trust or periodic payment plan by the issuer thereof;

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

(3) to borrow money or other property from such registered company or from any company controlled by such registered company (within the meaning of the term "controlled") except as permitted in section 21(d)(6) of this Act.

6. N.Y. State. Corp. V.S.C.C., 400, 401 (1941) ["The underlying assumption of section 17(a) . . . is that the risk of abuse when such transactions violate greatly outweighs any advantage which an investment company can derive in these circumstances when the transactions are scrupulously fair, but the only sound policy is to prohibit all such transactions unqualified."]


8. B., 1940 Senate Hearings at 80 (statement of Cyril J.C. O’Brien); 1940 House Hearings at 74.

To eliminate such self-dealing, section 17 of the Investment Company Act was enacted to make it unlawful for insiders to sell to, purchase from, or borrow from the investment company. These transactions were prohibited altogether, but the SEC was empowered to exempt transactions that conformed to specific standards. The Act requires prohibited transactions to be shown in advance of their execution to be reasonable and fair and not the product of overreaching by any person. The industry did not oppose this prohibition.

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APPLICATION OF SECTION 17

Section 17(a) makes it unlawful for any affiliated person1 of or any principal underwriter for a registered investment company, or any affiliated person of such an affiliate to underwrite, to effect certain transactions with the registered investment company or a company controlled by the investment company. To determine whether a company is "controlled" for purposes of section 17(a), the SEC will look through layers of companies—that is, as long as the registered investment company has control, the SEC will apply section 17(a) despite the existence of intervening companies. 2

The section prohibits transactions in which one party is an investment company, or a company controlled by the investment company,3 and at least one of the other parties is (1) an affiliated person of the investment company or an affiliate of the affiliate, (2) a principal underwriter for the investment company or an affiliate of the underwriter, or (3) a promoter of the investment company or an affiliate of the promoter. The prohibitions of section 17(a) are in addition to any other federal and state law restrictions on fiduciaries' dealings with their investment companies.4

If neither the investment company nor a controlled company is a party, section 17(a) does not apply5 For example, if Company A owns 5% of the voting securities of an investment company (and is thereby its affiliate) and the investment company owns 5% of the voting securities of Company B (and is thereby an affiliate), section 17(a) does not apply to a sale by Company A to Company B. If Company B is controlled by the investment company, however, or if any of the parties is an investment company, section 17(a) applies.

A sale by an affiliate of the investment company to an affiliate of the affiliate is also outside section 17(a), if neither the investment company nor a controlled company is a party. A director of investment company A (an affiliate of Company A) may therefore sell property to a company in which he has 5% of the voting securities, or of which he is a director (even though Company B is an affiliate of an affiliate), so long as the investment company is not involved, and the director or the company is not controlled by the investment company. A wholly owned subsidiary has the status of its parent for the purpose of determining whether a controlled company is a party. A transaction between a wholly owned subsidiary of a controlled company and an affiliate is therefore prohibited.6

EXEMPTIONS UNDER SECTION 17(b)

It was clear in 1940 that the sweeping prohibition of section 17(a) would not fit with the grant of exemptive powers to the SEC in section 17(b). The language of this section indicates that upon a finding of fairness the SEC should grant the exemption. The discretion of the SEC under its general exemptive power (in section 6(b)) is broader, since that section uses "may" rather than "shall," and its standards are less specific than the standards of section 17(b).7

Fairness is a federal question. A merger between an investment company and its controlled company that is

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1. Under section 2(a)(3) of the Investment Company Act, an affiliated person of another person is (A) any person directly or indirectly owning, controlling, or holding with power to vote, five percent or more of the outstanding voting securities of such other person. (B) any person five percent or more of whose outstanding voting securities are directly or indirectly owned, controlled, or held with power to vote, by such other person. (C) any person directly or indirectly controlling, controlled by, or under common control with, such other person. (D) any officer, director, partner, principal, or employee of such other person. (E) if such other person is an investment company, any investment adviser thereof or any member of an advisory board thereof, and (F) if such other person is an exempt public utility investment company not having a board or directors, the managing trustees. 68. S. J. de R. Neuman & Co., 41-880 (1947) (section 17(a) applies only when a controlled person of a registered investment company contracts with a person controlled of the controlled person). See also 1940 Seminar (Harvard) at 261.

10. See generally Analysis, Securities Transactions by Investment Companies, supra note 44 (1946); Report of S. Reg. & L. Rep. B-3 (Apr. 1, 1978;), I. G. Schurak (implies that section 17(a) is an absolute prohibition). 1940 House Hearings at 120.
11. The first draft of the 1940 Act prohibited an affiliate from dealing with the investment company or any of its affiliates. S. 398, Draft of May 24, 1940. The provision was later narrowed to controlled companies. 12. In American Food Equipment Co., 41-580 (1946), a company controlled corporate company E and E owned 57 percent of D. It also owned enough stock in E to be a controlling of D. A wholly owned subsidiary B, D controlled C, sold a wholly owned subsidiary D. A transaction between F and H fell within section 17(a) because at least one party was an affiliate and the other was a controlled company of an investment company.
13. See Frankfurter, supra n. 11, supra at 115.
found fair under state law does not necessarily satisfy section 17(a). 16

The SEC has consistently held that the proposed transac-
tion must be fair not only to the investment company but to all parties, 17 including the holders of different classes of stock in the investment company. 18 This SEC review has resulted in occasional disadvantages to investment companies, which may be required to pay more for the shares of another company than they could have bargained for. 19 The SEC has been criticized for not limiting itself to protection of the investment company as allegedly intended by Congress. 20 However, an agency entrusted with supervising the fairness of transactions could not be expected to stop short when it finds unfairness to one of the parties. Perhaps the apparent disadvantage in requiring an investment company to pay a fair price for stock may, in the long run, prove an advantage, avoiding costly and disruptive litiga-
tion. 21

To dispove overhearing, applicants should show that the fiduciaries involved did not breach their duty. When an affiliate insurance company, 100% owned of the investment adviser, gave its investment company a 20-day option to purchase a block of specified securities of an affiliate, the explanation indicated that the investment company did not take a corporate opportunity from the insurance company, because the latter had purchased the securities for the sole purpose of granting the option. In the judgment of the board, the


17. SEC v. Parizio Annuity Life Ins. Co. of America, 369 F.2d 690 (2d Cir. 1966) (SEC stated exception for loans to officers and directors of a variable annuity company which would not affect adversely the "investment com-
pany" by increasing shareholders, merely the variable annuity underwriters, but might affect the other shareholders of the company, specific exemp-
tion granted, 27 S.E.C. 584 (1965)).


ing companies (anomalous concept in securities offerings) are not sufficiently protected by the Act. David Schiderman, The General Council of the SEC, pointed out in the 1940 hearings that, notwithstanding concentration of interest in ordinary intercorporate transactions, a majority or controlling shareholder has a substantial state in the company, whereas a controlling person in an insurance company usually has no equity in transactions in such companies. The reality in the affiliated operating company is therefore exposed to a greater danger than in an insurance company affiliated. It is clear that Mr. Schiderman interpreted the mandate in section 17(a) to impose upon the SEC the duty to prevent from occurring the minority interests in affiliated operating companies. 1940 Senate Hearings at 208-209. The courts affirmed the SEC position. E. de Pont du Nord & Co. v. Collins, 19 supra, Collins v. SEC, 7, supra, at 23, SEC v. Starling Purchasing Corp., 19 supra.


of a licensed small business investment company was not second-guessed by the SEC when it decided to exchange a real estate company’s notes for notes and shares of a company that would hold the real estate company’s shares; the recategorization was effected to enable the real estate company to become eligible for an FHA commitment to insure income and mortgage on the real estate. However, business judgment must be based on the fullest considera-
tion of the data, especially when a proposed transaction cannot be tested against past experience. Thus, when an affiliate repurchased its own shares from the investment company, management’s decision was approved after the affiliate showed that its surplus was larger than the amount necessary for its business, that the problem of excess surplus had been studied for more than a year, and that in the opinion of experts repurchase of the company’s shares was also desirable because of the low price at which they had been traded.

Under section 17(b), a transaction between the investment company and an affiliate must be fair, but this does not necessarily require that they participate on equal terms. By contrast, section 17(d) focuses on dealings by the investment company and affiliates with third independent parties. The danger of abuse lies in unequal or undue treatment of the investment company or affiliate, via a-via each other, not by the third party. The assumption is that the third party can fend for itself. Section 17(d) provides protection for the weaker partner of one party to the transaction, the invest-
ment company, or the affiliate. If the terms of the agreement obtained by the stronger party for itself are equal to those of the weaker, the transaction may be presumed to be fair.

Since the effect of an exemption under section 17(b) is to permit a transaction, the SEC may take another route and exempt a party from the definition of an affiliate, under-
writer, or promoter. When an investment company is orga-
nized as a limited partnership, the members of the public who purchase the limited partnership interests are by virtue of section 2(a)(3)(B) affiliates of the partnership and may not deal with it. Whenever an investor renders his interest for redemption, section 17(b) applies, unless an exemption is required. To avoid this result, the SEC has exempted the limited partners of such a partnership from the definition of an affiliate.

The SEC tends to exempt transactions that affect only foreign issuers. The SEC granted exemption from sections 17(b) and (d) not only for specified transactions but also for future transactions that resulted from pressure from the government of Mexico on certain American companies to repatriate control of their Mexican subsidiaries. Most minority shareholders of the foreign subsidiary were foreign nationals, the United States investing public had no interest in the transactions, and the exemption facilitated the U.S. policy of encouraging such foreign transactions.

**PROCEDURE**

“Any person may be an applicant, but the application must contain a transaction of the applicant.” Not all parties to the transaction need file. An application filed by a board of directors of an investment company inadvertently elected in violation of section 16 will not be deemed invalid, and an exemption granted on the basis of such an applica-
tion is effective.

An exemption is available only if the transaction is prohibited. However, where it was not clear whether the parties were affiliated by control (in which case a loan between them would have to be exempted), and there was a cloud over the propriety of the transaction between them, the SEC granted an exemption from the section under 17(b) without prejudice to a decision on the control issue. The SEC has granted an exemption when the applicant stated that, although it believed that it was not affiliated with the other party to the proposed merger, it was requesting an exemption to remove any doubt as to its legality. Even though the parties believe that they are not affiliated, an exemption may be their best protection. The alternatives are possible violations or lengthy proceedings, for example under section 2(a)(9), to determine the existence of control.

29. McGuire, Cadw. Corp. v. SEC, 414 F.2d 4318 (1965), modifying SEC v. McEwen, 1963) (SEC was probably satisfied that the amendment was filed in time’s length). See also Aetna-Houghton Corp. v. SEC, 432/440 (1965) (the SEC did grant an exemption for further substantial investments by a investment company in an affiliate that operated continuously in a defect, whose plan was that such continued material modifications the previous year, and which was closed debited).

30. Valley Indus. Inc. v. SEC, 564 F.2d 163 (1977) (SEC refused to grant exemption unless merger agreement was made to take into account the uncertain future of one of the companies).

31. Hartford Steam Boiler Inspection & Ass. Co. v. SEC, 617 F.2d 313 (2d Cir. 1980).


36. Incorporated Income Fund, 416 6712 (1976). See also Silverman v. Camfield Balanced Fund, Inc., 616/642 (1976) (relationship among the parties to proposed transaction is so close that a question may arise as to whether section 17(a) applies).

37. The staff may raise the control issue even when reacquisition of control events, and the applicant may select the exemption range without qualifying that affiliation exists. See, e.g., Television-Electronics Fund, Inc. v. SEC, 459/460 (1976). After applicant brought suit to rescind sale, the parties settled. The seller agreed to deliver to the applicant 37,000 additional shares and pay $16,000,000 to cover the expenses of the litigation in schedule for a release from all claims by the applicant. The applicant must get it was not to be renewed as a matter of the remedy, whether any of any rights to take the position that the proposed transaction is not prohibited by . . . Sec. 17(a).

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The SEC examinees applications before granting an
exemption, whether or not they are contested, as required
by section 17(b). 37 Part of this examination is conducted
before the application is published. Prior to filing, the
applicant describes the proposed transaction to the
staff, which may conduct an informal investigation and request
additional information. The submitted application, which
incorporates conditions and changes suggested by the staff,
and the assertions and reservations of the applicant, is then
published pursuant to the SEC Rules of Practice. 38 The SEC
has held that shareholders of an applicant are not entitled to
have a copy of the application sent to them. The require-
ments of the Act are satisfied by a notice of a public hearing
published in the Federal Register, giving shareholders an
opportunity to appear at the meeting, produce evidence,
and state their views. 39
If no request for a hearing is made, the application will be
granted. However, the staff warned applicants recently not to
take this practice for granted and enter into any transac-
tions before the application is actually granted.40
If the staff does not agree with the applicant, or if a
justifiable request for a hearing is made, the SEC will hold
hearings after appropriate publication of a notice. If the
person seeking a hearing cannot show in his request a legal
or factual basis for denying the application, the SEC may
refuse to hold a hearing. 41 Similarly, no re-hearing will be
granted when the petitioners have raised nothing new.42
During the proceedings the applicant may be encour-
aged to change the terms of the transaction, most commonly
the price. 43 In the case of Standard American Industry
Fund, Inc. 44 three investment companies with interlocking
directors and the same adviser proposed to merge. Under
the advisory contract, the investment adviser had to reim-
burse each company to the extent of expenses that it incurred
over 1% of the value of its assets. Because the net
assets of one company had declined since the application,
the adviser would have benefited from the economies of size
produced by the merger. Consequently, the amended appli-
cation stated that the adviser would bear a higher percentage
of the cost of the merger.

The burden of justifying the exemptions is on the appli-
cant. The SEC has required a showing as to various
measures of value, such as liquidating value of the entire
prize or a going concern. 45 It gives weight to expert testi-
mony of disinterested witnesses and data prepared by
government agencies. 46 In LaSalle-Street Capital Corp., the
SEC considered an application under section 17(b) regard-
ing a merger. In support of fairness, the applicant produced
a report by an investment and financial analyzer who
was retained by body managing corporations to make a pul-
liminary feasibility study of the merger. The report was favor-
able but did not contain an opinion as to the fairness of the
merger. The staff argued that the applicants did not meet
their burden of showing fairness; much of the evidence
was general and did not specifically show the relative contri-
bution of the shareholders of each company. The SEC
approved the merger, but it remarked:

Apartment might have been better served in asserting its burden of proving the availability of an exemption if Duff (the analyst) had been specifically requested to, and had made, a specific evaluation of each company for the purposes of merger approval. If the companies had specifically engaged Duff to determine a definitive basis for the merger, it would have been a report prepared for such an engagement which would have carried more weight and a hearing might thereby have been avoided. 47

38. SEC Informal and Other Procedures Section 202.1-4; Rule 0-5 under the
Investment Company Act.
39. Capital Administration Co., Inc. v. SEC (1953) (The shareholders also
required a 60-day period between the mailing of the application and the
hearing. The SEC granted a stays-key writs pending).
40. IC 826 (1974).
41. e.g. Highland Corp. Cap. Co. v. SEC 4667/1 (1971).
42. Christianson Sec. Co. v. SEC (1977), see Grisso v. SEC 418 F.2d 101, 108
(2d Cir. 1960); SEC Rules of Practice section 201.21(a).
43. Talley Index, Inc. v. 29, supra, Petitioners Index, 32 S.E.C. 62, 63
(1935) (applicant changed merger plan substantially); Morris Plan Co. of
America, Inc. v. SEC 202.1 (1977); Atlas Corp. v. SEC, 23 S.E.C. 335
(1965); Pittsburgh Coke & Chem. Co. v. SEC 7241 (1970); merger, composition of net
assets value changed); Berkley Index, Inc. v. SEC 5956 (1969) (original offer of
$727 appeal to $727 and at the date of the mailing to $775. Applicant (did
request to merger the hearing to introduce additional evidence and at
merger hearing offered $825). When this offer was not accepted by the
other party, the applicant withdrew).
44. NA-S-546.1.1 (1973), see Aberdeen Management Corp., IC 720/3755
(1972).
45. LaSalle St. Cap. Corp. v. SEC 1551, 1567 (1974); Spector, Howard Inc.
Corp. v. SEC 17 S.E.C. 703, 710 (1944) (application denied in the absence of a
showing of fairness and probity).
46. LaSalle St. Cap. Corp., n. 45, supra.
47. Talley Index, Inc. v. 29, supra, at 817 (the SEC noted that the applicant
ruled heavily on estimated future growth of a highly new product, that the
prospect was not assumed by an independent originator, and that no market
study or technical data evaluation was made. Proposed merger was held
rever, and was conditioned in clause just in terms of the merger); Morris Plan Co. of
America, Inc., n. 45 supra; Pennsylvania Index, Inc., 24
S.E.C. 246 (1966) (evaluation of a building by an independent appraisal
professional); Tunney Index, Inc. v. 41, supra, (the SEC approved three
interested witnesses offer); LaSalle Corp., 23 S.E.C. 472 (1964); United States
Trading Co., 17 S.E.C. 422, 426 (1964) (opinion of real estate and
leasing by independent appraiser); Epper Corp. 15 S.E.C. 105, 107 (1953)
(opinion of "executive of a reputable real estate firm" used as fair
value); Spector, Howard Corp. v. SEC 7241 (1970); (opinion of a
financial research organization to evaluate the value of shares, see Face the Facts, Inc. v. 17, supra).
48. N. 45 supra.
49. Id. at 663.

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An applicant that did not produce sufficient data to show fairness of the price was denied an exemption. In one case, the SEC permitted the applicant to submit further data and, in the process, to improve the price, which it then found to be fair. If a prima facie case is established, an objector to the application must do more than merely assert that the transaction involves overreaching; he must produce some proof of it.

In general, the SEC either approves or denies an application. In one exceptional case, over the dissent of a Commissioner, the SEC granted an exemption to a proposed plan of merger as specifically amended by the SEC instead of limiting itself to the terms of the application.

WITHDRAWAL OF APPLICATION

An application for exemption may be withdrawn, presumptively with SEC approval. The SEC has not denied approval when the application was opposed on collateral issues as to the legality of earlier transactions, and the termination of the hearings on the application does not bar the objectors from raising the same issues in another forum. When the parties decide to abandon the proposed transaction, the SEC will not deny the application to withdraw simply because the opposing parties like to continue to resolve issues that were raised by the application.

ACCOUNTING DEVELOPMENTS

By Dennis S. Neier and Charles Hartlorn

SEC INCREASES THE SMALL OFFERING EXEMPTION

The Securities and Exchange Commission has amended Regulation A, the small offering exemption, to increase the aggregate amount of securities that may be sold within a 12-month period from $500,000 to $1,500,000, and to increase the amount of securities that may be sold without an offering circular from $50,000 to $100,000. The major advantage of the regulation A procedure is its exemption from the standard registration requirement to file audited financial statements for the three preceding fiscal years and other schedules and financial data called for by regulation S-X. However, many underwriters, as well as the securities laws of many states, may require audited financial statements even for small offerings.

The SEC indicated that, despite the primary purpose of regulation A to provide a simple and relatively inexpensive procedure for small businesses to raise capital, the number of issuers using the exemption had declined drastically during the past five years. The primary reasons for this are the loss of interest by investors in issues of relatively new companies and the difficulty of finding an underwriter to handle a small issue. We question whether, in today’s inflationary cost structure, raising the registration A, would be

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