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Mutual Fund Investment Limitations Arising Outside of the Investment Company Act

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In addition to limitations that apply to every registered investment company (Fund) under the Investment Company Act of 1940 (ICA), there are investment limitations under other federal laws and under state law, each of which is a potential trap for a Fund. Violations of any investment limitation may result in penalties or even forced divestment and, therefore, Funds and accounts under common control should be monitored to assure compliance with non-ICA limitations. This article provides guidance to Funds and their advisers to avoid the most common of these non-ICA limitations.

Overview

In general, the non-ICA investment limitations are not directed specifically at Funds but, instead, are concerned with changes in control of issuers that are deemed to be engaged in a business affecting the "public interest."

We are aware of 17 non-ICA limitations, each of which limits ownership of a different class of issuer.[1] However, we believe that only six of these limitations are likely to be encountered with some frequency by Funds and accounts under common control. Exhibit 1 lists those six classes of issuers. For informational purposes, Exhibit 2 lists the remaining non-ICA limitations that Funds encounter infrequently.[2]

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Exhibit 1

More Frequently Encountered
Banks and bank holding companies
Gaming and casino companies
Insurance holding companies
Issuers with poison pills
PFICs
Broadcast licensees

Exhibit 2

Infrequently Encountered
Newspapers
Railroads, water carriers, and trucking companies
Manufacturers of gaming machinery
Federal mineral lessees
Nuclear power licensees
Small business investment companies
CFTC-regulated entities
Hart-Scott-Rodino Act
REITs
Public service companies
Issuers subject to state anti-takeover legislation

Practical Guidance—Six Limitations

This article takes the following approach. For each of the six more-frequently encountered non-ICA investment limitations, the source of the limitation is identified, and the threshold limitation is described. Guidance is provided concerning when it is appropriate to aggregate the holdings of Funds and accounts under common control toward the relevant limitation. Finally, the effect, if any, of passive increases above the limitation due to actions beyond the control of the adviser (for example, an issuer's repurchase of its own shares) is described.

An important caveat: Some of the suggestions in this article, because they are based on the authors' personal experiences, are impressionistic. When impressionistic guidance is offered, the underlying reason usually is either ambiguity in applicable law (for example, is aggregation of Funds and accounts sharing a common adviser required?) or the inability to generalize about limitations that vary significantly (for example, a limitation that varies from state to state).

1. Federal Law Limitations on Acquisitions of Banks, Thrifts, and Their Holding Companies

Source of Limitations: The Bank Holding Company Act,[3] the Savings and Loan Holding Company Act[4] and the Change in Bank Control Act[5] are the primary federal statutes regulating the acquisition of the voting securities of banks, thrifts *and* their holding companies (banks). There are variations among the statutes and regulations administered by the federal banking regulators. The descriptions that follow are summaries only.

Relevant Thresholds: The Bank Holding Company Act and the Savings and Loan Holding Company Act require prior approval and registration as a holding company if a company acquires "control" of a bank. Acquisitions of control of a bank by an individual or group acting in concert are subject to the prior approval requirements of the Change in Bank Control Act. All of these statutes define control as the power to vote 25 percent or more of any class of voting securities of a bank or to direct the management and policies of the bank.[6] However, the federal banking agencies have established by regulation a rebuttable presumption that control arises at 10 percent voting stock ownership.[7]

Federal banking regulations require 60 days' written notice to the appropriate federal regulator (including the publication of a newspaper announcement) *before* an acquirer acquires 10 percent or more of a bank's voting stock. Significantly, however, each of the banking agencies permit acquirers to rebut the presumption of control and thereby avoid the notice and filing requirements.[8] Requests to rebut a presumption of control may be made in writing (and sometimes orally at informal meetings with representatives of the applicable banking agency). Although rebuttals of the presumption of control are usually made on a case-by-case basis, we are aware of advisers to Fund complexes that have obtained a "blanket" rebuttal of control from certain federal banking agencies.[9] This relief typically is conditioned on the adviser agreeing on behalf of the Funds and accounts:

1. To certain "passivity" terms, whereunder the adviser agrees not to seek to influence the management of any bank; and
2. Not to acquire more than a specific percentage of a bank's voting stock.[10]

The obvious benefit of this type of relief is that the adviser does not have to obtain pre-approval every time it anticipates acquiring more than 10 percent of a bank's voting stock.

Aggregation Requirements: The federal banking regulations in this area extend not just to acquisitions by individual clients, but also to situations in which multiple parties are deemed to be acting in concert, which is defined and interpreted very broadly.[11] Accordingly, Funds with common boards of directors and officers may need to aggregate their holdings of any voting stock of a bank when determining whether the 10 percent rebuttable presumption of control applies. Similarly, an investment adviser that has voting power or investment discretion over a bank's voting securities on behalf of multiple clients may need to aggregate the holdings.

Passive Increases: If an acquirer's holdings in a bank increase over the 10 percent threshold due to repurchases by the bank of its stock, the acquirer is not required to comply with the prior notice requirement, but must report the increased ownership to the applicable regulator within 90 days.

2. State Law Limitations on Acquisitions of Casino and Gaming Businesses

The relative lack of uniformity among the states requires an adviser to monitor acquisitions in this industry closely, and to give careful attention to the aggregate ownership levels of the relatively finite number of issuers within this category. In view of the disparities among the relevant states, advisers should approach the 5 percent threshold very cautiously. Establishing a relationship with in-state gaming counsel beforehand may be desirable if an adviser foresees that it will exceed that threshold with respect to any issuer.

Source of Limitations: Under the laws and regulations of at least 18 states, the limitations regarding the acquisition of securities (usually, but not always, of the issuer's *voting* securities) of casino and gaming businesses vary widely.[12]

Relevant Thresholds: Although there is no general rule, most states have either a single threshold or a multi-threshold scheme. For states that have a single threshold (12 in total, including Louisiana and New Jersey), the threshold is either 5 percent or 10 percent. Typically, notice to the state regulator and approval is required before an acquirer can exceed that level of ownership.

States that have a multi-threshold scheme (six in total, including Mississippi and Nevada) usually have a first threshold of 5 percent, and the significance of that threshold usually is analogous to the single-threshold schemes. The second or third thresholds are frequently more than 5 percent or more than 10 percent, respectively. These higher thresholds trigger a greater level of regulatory scrutiny.[13]

In three of the six multi-threshold states (Michigan, Mississippi, and Nevada), institutional investors may apply for a waiver of some or all of the intermediate regulatory requirements.[14]

Aggregation Requirements: Guidance is sparse on whether Funds and accounts with a common adviser must be aggregated.

Passive Increases: There is little guidance on the effect of passive increases.

3. State Law Limitations on Acquisitions of Insurance Holding Companies

Funds and their advisers should monitor acquisitions in this industry closely. A "parent" insurance holding company may have subsidiary licensed insurers in multiple states.

Source of Limitations: Limitations on the acquisition of insurance companies are uniform across most states due to the near-universal adoption of the Insurance Holding Company System Regulatory Act produced by the National Association of Insurance Commissioners.

Relevant Thresholds: The relevant threshold in every state, except Alabama and Florida, is 10 percent of an insurer or its parent company's voting securities. In Alabama and Florida, the relevant threshold is 5 percent.

Before an acquirer crosses the 5 percent or 10 percent threshold, the acquirer is required to file a disclaimer of control with each state in which the holding company has registered an insurer subsidiary.[15] (Thus, before an acquisition program of an insurance holding company commences, it is important to know in which states the holding company has registered insurer subsidiaries). The disclaimer is filed with the relevant states' insurance regulators.

We have found it helpful for a passive acquirer, in the disclaimer, to state its intention to acquire up to 14.9 percent (or 9.9 percent in Florida and Alabama) and to emphasize its passive-investor status. After the receipt of the disclaimer, the state regulator typically has a 60 to 90 day period to object, after which the disclaimer is deemed accepted.

Aggregation Requirements: Aggregation normally is determined by an adviser's power to vote the securities.

Passive Increases: If an acquirer's holdings in an insurance company or its parent increase over a threshold due to repurchases by the issuer, it should be treated as triggering the disclaimer obligations.

4. Issuer Limitations—Poison Pills

The lack of uniformity among issuers' shareholders rights plans (or poison pills) requires an adviser to monitor closely acquisitions of issuers with such plans. Our experience is that issuers are willing to amend their plans in order to accommodate a well-recognized, passive institutional investor.

Source of Limitations: An issuer's shareholders rights plan. The plans are publicly filed and, therefore, available on the Securities and Exchange Commission's EDGAR database. In addition, the identity of issuers with rights plans and copies of the plans can be found on subscription-based Web services.

Relevant Thresholds: There is no standard threshold for rights plans. Applicable thresholds can be 10 percent, although 15 percent and 20 percent are common too. It is necessary to refer to specific provisions of each issuer's rights plan.

Aggregation Requirements: Aggregation typically depends on "beneficial ownership," as defined in Rule 13d-3[16] under the Securities Exchange Act of 1934. Thus, an adviser that votes the securities or has dispositive power over the securities will be deemed the beneficial owner.

Passive Increases: Many rights plans accord an investor that inadvertently has crossed the poison pill's threshold a short opportunity (for example, 30 days) to sell down below the threshold before the poison pill is triggered.

5. Federal Taxation of Passive Foreign Investment Companies (PFICs)

In view of the potential negative tax implications of failing to report investment income from PFICs, advisers should consider carefully investments in entities that are PFICs or that appear to be PFICs. Tax counsel should be consulted when in doubt.

Source of Limitations: Under the Internal Revenue Code (IRC), PFICs are those foreign corporations that generate primarily "passive income." Passive income is defined as any income that is considered foreign personal holding company income under the IRC.[17] For federal tax purposes, a foreign corporation is deemed to be a PFIC if 75 percent or more of its gross income during a fiscal year is passive income or if 50 percent or more of its assets are assets that produce, or are held to produce, passive income.[18]

Relevant Thresholds: Funds and other accounts advised by the same adviser may invest in foreign Funds to gain exposure to the securities of companies in countries that limit or prohibit direct foreign investment. Foreign Funds generally are deemed to be PFICs because nearly all of their income is passive income. Severe penalties exist under the IRC for failure to report investment income from PFICs.[19]

6. Acquisition of Federal Communications Commission Licensees

Source of Limitations: Federal Communication Commission (FCC) rules limit investments in radio, television stations, and cable systems (broadcast licensees). Depending on the market, the FCC limits the number of broadcast licensees in which a party can hold a "cognizable interest."[20]

Relevant Thresholds: Under FCC rules, passive investors such as investment companies are deemed to hold a cognizable interest in a broadcast licensee if they own 20 percent or more of the outstanding voting stock of the licensee.

Aggregation Requirements: Holdings by investment companies under common management must be aggregated.[21]

Passive Increases: Unknown.

Conclusions

As counsel to Funds and their advisers, it is natural to focus on investment limitations arising under the ICA. The same may be true when advising compliance personnel or vetting compliance tests and software. Unfortunately, as this article describes, there are non-ICA investment limitations that apply to Funds and accounts under common control. The non-ICA limitations discussed in this article exist under US federal or state law. Funds and accounts under common control that invest outside of the US should be aware that non-US jurisdictions frequently have their own investment limitations and notification requirements.

Funds ignore these limitations at their peril because violations of any limitation may result in penalties or even forced divestment. Therefore, Funds and accounts under common control should be monitored to assure compliance with these non-ICA limitations.

NOTES

1. The Investment Company Institute (ICI) publishes a useful guide to non-ICA investment limitations. The guide describes sixteen non-ICA investment limitations. *See* ICI, Summary of Non-1940 Act Investment Restrictions (2005).

2. We do not discuss the limitations identified in Exhibit 2 due to the relative infrequency with which, we believe, Funds and accounts under common control encounter these limitations.

3. 12 U.S.C. §§ 1841 *et seq.*

4. 12 U.S.C. §§ 1467 *et seq.*

5. 12 U.S.C. § 1817(j).

6. 12 U.S.C. § 1841(a)(2), 12 U.S.C. §§ 1467a(j)(2), 1817(j)(8)(B).

7. 12 C.F.R. §§ 5.50(f)(2)(ii), 225.41(c)(2), 303.82(b)(2), 574.4(b)(1)(i).

8. 12 C.F.R. §§ 5.50(f)(2)(v), 225.41(g), 303.82(e), 574.4(e).

9. Specifically, the Federal Reserve Board and the Office of Thrift Supervision (OTS) provide blanket relief but, to our knowledge, the FDIC and the Office of the Comptroller of the Currency do not.

10. For the Federal Reserve Board, the relief granted typically is up to 15 percent of a bank's voting stock and, for the OTS, it is up to 25 percent of a bank's voting stock.

11. 12 C.F.R. §§ 5.50(d)(2), 225.41(d), 574.4(d).

12. In addition, we are aware that Pennsylvania regulates the ownership of manufacturers of gaming machines. In Pennsylvania, an institutional investor (which, by definition, includes a registered Fund) that owns voting securities of a publicly traded and licensed manufacturer of gaming machines is required to file a notice with, or otherwise seek exemption from the license requirements of, the Pennsylvania Gaming Control Board. *See* 58 Pa. Admin. Code § 433a.5.

13. For example, in Mississippi, any person who acquires beneficial ownership of any voting security of a publicly traded corporation registered with the gaming commission may become subject to a suitability requirement (however, there is no notice requirement). An acquirer of more than five percent of such an issuer's voting securities is subject to a notice-filing requirement and may be subject to a suitability determination. An acquirer of more than 10 percent must apply for a finding of suitability with the state regulator after notifying the state regulator.

14. Thus, in Mississippi, an institutional investor that becomes a beneficial owner of more than 5 percent of the voting securities of a gaming licensee may apply for a waiver of any licensing requirement, if the investor owns less than 15 percent.

15. We are aware of passive institutional investors that, despite the clear legal requirement to file the disclaimer before exceeding the relevant threshold, instead file after crossing the relevant threshold, once an acquisition program is completed. At least one jurisdiction seems to reject this approach. *See http://www.insurance.wa.gov/orders/proceedingsDocuments/G07-11otp_000.pdf* (last visited April 8, 2009).

16. 17 C.F.R. § 240.13d-3.

17. IRC §§ 1297(b), 954(c).

18. IRC § 1297(a).

19. IRC § 1291.

20. A "cognizable interest" is defined as any interest direct or indirect that allows a person or entity to own, operate or control . . . a broadcast station." *See* 47 C.F.R. § 73.3555.

21. Different rules apply if a Fund's holdings are custodied other than with a bank.

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