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Investment Company Act Considerations in Financing and Real Estate Transactions

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Transactional lawyers advising on finance, real estate, or other corporate deals have numerous issues to analyze throughout the course of a transaction. These range from timing to commercial terms to tax structuring. One important issue that may not be at the forefront of a transactional lawyer's mind is whether any entities involved in a transaction—because of their operations generally, as a result of the transaction itself, or otherwise—would be subject to the Investment Company Act of 1940 (the 1940 Act).

If an entity falls within one of three nonexclusive definitions of "investment company" under Section 3(a)(1) of the 1940 Act, absent an exemption or exception, it is subject to numerous restrictions and obligations. While these regulations are appropriate for traditional mutual funds, operating companies and other structuring entities (such as intermediate holding companies) would not be able to conduct their business or serve their purpose in a corporate structure if subjected to the full slate of regulations under the 1940 Act.

When companies run afoul of the often-complicated numerical tests under Section 3, or otherwise lose their ability to rely on an appropriate exemption or exception, the consequences for their investors, lenders, and other counterparties can be significant. For this reason, in connection with certain transactions (finance and real estate transactions, for example), companies are often required to obtain an opinion of legal counsel and to make representations and covenants relating to, among other things, the status of the company and certain of its related entities (each such company referred to herein as a Transaction Entity and, collectively, Transaction Entities) under the 1940 Act. The analysis required to issue such an opinion is based on the unique characteristics of each Transaction Entity within the relevant corporate structure and typically is fact intensive.

This article summarizes the various tests and definitions under Section 3 of the 1940 Act and discusses some of the common exemptions and exceptions from the definition of investment company[1] relied on in finance and real estate transactions.

Definition of "Investment Company"—Section 3(a)(1)

When considering the implications of the 1940 Act for a Transaction Entity, the particular language of an opinion or representation requested by an investor, lender, or counterparty to a transaction is critical. It is typically desirable to negotiate the wording of these provisions to provide a Transaction Entity with maximum flexibility to rely on one or more exemptions or exclusions from the definition of "investment company." The requisite 1940 Act opinion or representation generally is framed in one of two ways: (1) that the Transaction Entity is not an investment company under the 1940 Act;

or (2) that the Transaction Entity is not required to register as an investment company under the 1940 Act. Though a subtle difference, the second option provides the Transaction Entity more flexibility to rely on an available exemption or exclusion from registration, notwithstanding that it may meet the definition of "investment company" in Section 3.[2] In either option, the first step when assessing a Transaction Entity's ability to make the representation is to determine whether it meets the definition of "investment company."

If a Transaction Entity falls within any one of the three nonexclusive definitions contained in Section 3(a)(1) of the 1940 Act, it will be considered an investment company, absent an available exemption or exclusion. The two most relevant definitions[3] relate to an issuer that (1) "is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading in securities,"[4] or (2) "is engaged or proposes to engage in the business of investing, reinvesting, owning, holding, or trading in securities, and owns or proposes to acquire investment securities having a value exceeding 40 per centum of the value of such issuer's total assets (exclusive of government securities and cash items) on an unconsolidated basis."[5]

Each of these definitions requires that an "issuer" partake in the activities described. Therefore, to be an investment company, the Transaction Entity in question must be an issuer of securities. Section 2(a)(22) of the 1940 Act defines "issuer" as "every person who issues or proposes to issue any security or has outstanding any security which it has issued." Three questions arise based on the definition: (1) who is a person;[6] (2) what is a security; and (3) when has a person issued a security?[7] In many transactions, the principal query in relation to the issuer definition tends to be whether the notes or interests representing ownership of an entity are securities as defined under the 1940 Act.

Section 2(a)(36) of the 1940 Act contains an expansive definition of "security."[8] Because the principal function of the 1940 Act is to oversee investment companies in "the business of investing, reinvesting, or trading in *securities*" (emphasis added), the definition of "security" is crucial to the 1940 Act's regulatory framework. The Staff of the Securities Exchange Commission (SEC) has frequently taken the position that the boundaries of what constitutes a "security" under the 1940 Act are not coextensive with those under other federal securities laws, and has consistently construed the term more broadly under the 1940 Act. For example, the Staff has indicated in no-action letters that certain instruments, such as promissory notes and loan participations, thought not to constitute securities under the Securities Act of 1933 (the 1933 Act) and the Securities Exchange Act of 1934 (the 1934 Act) at the time of the guidance, did in fact qualify as securities under the 1940 Act.[9] Therefore, careful consideration is warranted where a Transaction Entity believes it may have an argument that the instruments it issues are not "securities" as defined under the 1940 Act.

In certain contexts, it may be possible to take the position that an instrument, such as stock or a limited liability company interest, should not be treated as a security notwithstanding that on its face it appears to fall squarely within the definition. Such a position would be based on positions taken by the Staff in the context of joint ventures, where the owner of the "security" was involved in the management of the joint venture to such an extent that its ownership interest did not constitute a "security" based on the factors first put forth in *SEC v. W.J. Howey Co*.[10] Any such determination would be extremely fact intensive and a full discussion goes beyond the scope of this article.

Assuming a Transaction Entity is an issuer of securities, the next step in the analysis is to determine whether the Staff may deem the entity to be holding itself out as an investment company or engaged primarily in an investment company business within the meaning of Section 3(a)(1)(A), or whether the entity meets the 40 percent test described in Section

3(a)(1)(C). Since most Transaction Entities do not fall within the definition under Section 3(a)(1)(A) given they do not hold themselves out as being engaged primarily in an investment company business,[11] Section 3(a)(1)(C) is often the primary focus of analysis.

Section 3(a)(1)(C) is intended to reach issuers that, while not necessarily conforming to the popular perception of an investment company, nonetheless hold such a substantial portion of their assets in investment securities that Congress believed their shareholders might need the protections of the 1940 Act. Issuers described in Section 3(a)(1)(C) but not in Section 3(a)(1)(A) (that is, issuers that do not meet the "holding out" and "engaged primarily" requirements) are sometimes referred to as "inadvertent investment companies." An important difference between Section 3(a)(1)(A) and Section 3(a)(1)(C) is that Section 3(a)(1)(C) applies a 40 percent test relating to an issuer's investments in "investment securities"—a narrower subset of "securities." Investment securities are all securities excluding government securities,[12] interests in employees' securities companies and securities issued by majority-owned subsidiaries[13] of the owner which (i) are not investment companies, and (ii) are not relying on the exception from the definition of investment company in Sections 3(c)(1) or 3(c)(7).[14]

The 40 percent test is calculated on an unconsolidated basis, meaning that assets held through subsidiaries are not included in the calculation of the issuer's investment securities. Rather, the value of securities issued by nonqualifying subsidiaries is included in the issuer's total assets as investment securities for purposes of the 40 percent test, whereas securities issued by majority-owned subsidiaries are included as "good assets" under the test.[15] Another important point in the consolidation analysis is that even where a subsidiary may technically be "majority-owned" by the issuer, where the "majority-owned subsidiary" itself meets the definition of investment company in Section 3, or relies on the exceptions from the definition of investment company in Sections 3(c)(1) or 3(c)(7), its assets are considered "bad assets" for purposes of the issuer's 40 percent calculation. Because of this, analysis of an issuer's investment company status frequently requires analysis of its subsidiaries' investment company status as well.

Exclusion for *Prima Facie* Investment Companies—Rule 3a-1

Rule 3a-1 provides that an issuer that meets the definition of "investment company" in Section 3(a)(1)(C) may nonetheless be excluded from the definition of investment company, provided that such issuer meets the three requirements below.[16]

1. No more than 45 percent of the value of its total assets (exclusive of government securities and cash items) consists of, and no more than 45 percent of its income is derived from, securities other than government securities, securities of employees' securities companies, securities of majorityowned subsidiaries (other than subsidiaries relying on the exclusion in Section 3(b)(3) or Section 3(c)(1) of the 1940 Act), or securities of companies "controlled primarily" by the issuer through which the issuer engages in a non-investment company business;
2. It is not an investment company as defined in Sections 3(a)(1)(A) or 3(a)(1)(B); and
3. It is not a "special situation investment company."[17]

The Rule 3a-1 safe harbor is similar to the quantitative test in Section 3(a)(1)(C) but adds companies "controlled primarily" by the issuer to the list of "good assets" for purposes of the calculation and allows for a higher percentage (45 percent instead of 40 percent) of "bad assets." It also includes an income test to go along with the assets test. The total assets and net income tests in Rule 3a-1 are determined on an unconsolidated basis, except that the issuer consolidates the holdings of its wholly owned subsidiaries with its own holdings, meaning that for purposes of the calculations, the issuer treats the

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assets and income of the wholly owned subsidiary as if the assets were held and the income was earned by the issuer.

In order to determine whether a company is "controlled primarily" by an issuer, and therefore eligible to be a "good asset," the first inquiry is whether it is controlled and the second is whether it is "controlled primarily." Section 2(a)(9) of the 1940 Act defines "control" as "the power to exercise a controlling influence over the management or policies of a company, unless such power is solely the result of an official position with such company."[18] Neither the 1940 Act nor the rules thereunder define the term "controlled primarily," but the Staff has indicated that a company controlled primarily by any person is a company in which the degree of such person's control is greater than that of any other person.[19]

The definition of "majority-owned subsidiary" is the same as that discussed for purposes of Section 3(a)(1)(C) above other than the fact that Rule 3a-1 does not carve out subsidiaries relying on the exclusion from the definition of investment company in Section 3(c)(7) of the 1940 Act. Therefore, majority-owned subsidiaries that do not publicly offer their securities and whose outstanding securities are owned exclusively by persons who are qualified purchasers would be "good" assets under Rule 3a-1 where they would otherwise be "bad" assets under Section 3(a)(1)(C).

As noted above, Rule 3a-1's 45 percent test applies to both the assets and income of an issuer. An issuer satisfies the income test where no more than 45 percent of its net income after taxes, as measured over the last four fiscal quarters combined, is derived from securities other than those specifically carved out by Rule 3a-1's terms. If a company experiences a net loss during the past four fiscal quarters combined, it satisfies the income test if (1) it has both a net investment loss and a total net loss, and (2) no more than 45 percent of its total net loss after taxes is derived from investment activities in securities other than those of "good assets."[20]

The 45 percent asset and income tests are each determined on a semi-consolidated basis. Each test is determined on an unconsolidated basis other than with respect to wholly owned subsidiaries. Therefore, an issuer must consolidate its financial statements with those of its wholly owned subsidiaries[21] such that the issuer treats the assets and income of the wholly owned subsidiary as if the assets were held and the income was earned by the issuer. Similar to the test provided by Section 3(a)(1)(C), an issuer must determine whether the securities of majority-owned subsidiaries are "good" or "bad" assets.

Exceptions for Receivables Acquisitions, Loan Issuances, and Real Estate—Section 3(c)(5)

In the event that a Transaction Entity does meet the definition of an investment company in Section 3(a), it might still be excepted from the definition of investment company by Section 3(c) of the 1940 Act. An entity meeting the definitional requirements of one of Section 3(c)'s subsections is not an "investment company" notwithstanding that it meets the definition of investment company in Section 3(a) of the 1940 Act.[22] Although this article focuses on the exclusions in Section 3(c)(5) and Section 3(c)(6), Sections 3(c)(1)-(14) of the 1940 Act except various types of entities from the definition of investment company, including banks and insurance companies (Section 3(c)(3)), oil and gas companies (Section 3(c)(9)), charitable organizations (Section 3(c)(10)) and pension plans (Section 3(c)(11)).

In certain transactions, investors or transaction counterparties will also require an opinion and/or representation that a Transaction Entity is not a "covered fund" within the meaning of the Volcker Rule. The Volcker Rule generally prohibits banks from conducting certain activities and limits their dealings with "covered funds."[23] The Volcker Rule defines "covered fund," in relevant part, to include "an issuer that would be an investment company, as defined in Section 3 of the [1940 Act], but for Section 3(c)(1) or 3(c)(7) of that Act."[24] As a threshold

matter, if an issuer is not an investment company as defined in Section 3 of the 1940 Act, then it would not meet the definition of "covered fund." If, however, an issuer does satisfy the definition of an investment company in Section 3, it must seek to rely on an applicable exemption or exclusion. For ease of administration and monitoring, many entities rely on the statutory exclusions under Section 3(c)(1) and Section 3(c)(7) for certain limited private offerings, but an issuer representing that it is not a covered fund must satisfy an alternative exemption or exclusion, which often can be more challenging.

Section 3(c)(5) provides three often relied-on exceptions in the transactional context. It excepts

> Any person who is not engaged in the business of issuing redeemable securities, face-amount certificates of the installment type or periodic payment plan certificates, and who is primarily engaged in one or more of the following businesses: (A) purchasing or otherwise acquiring notes, drafts, acceptances, open accounts receivable, and other obligations representing part or all of the sales price of merchandise, insurance, and services; (B) making loans to manufacturers, wholesalers, and retailers of, and to prospective purchasers of, specified merchandise, insurance, and services; and (C) purchasing or otherwise acquiring mortgages and other liens on and interests in real estate.

The first element of Section 3(c)(5) is that the person "is not engaged in the business of issuing redeemable securities, face-amount certificates of the installment type or periodic payment plan certificates." Because face-amount certificates of the installment type and periodic payment plan certificates are not typically relevant to an issuer's analysis in these transactions, we discuss only redeemable securities here. A "redeemable security" is one that, by its terms, entitles the holder, upon presentation, to receive approximately its proportionate share of the net assets of the issuer of such security, or the cash equivalent of such share (the classic example being a share of a mutual fund).[25] The Staff has issued a fair amount of guidance as to what is and what is not a redeemable security and the analysis generally focuses on the degree of restriction on redemption of a particular security.[26] The more impediments to redemption, the more likely a security would not be a redeemable security and therefore the more likely a Transaction Entity would be eligible for one of the exceptions discussed further below.

Financing Interests—Sections 3(c)(5)(A)-(B)

The second element of Section 3(c)(5) is that the issuer be "primarily engaged" in one of the activities described in the sub-sections of 3(c)(5). While "primarily engaged" is not defined under the 1940 Act, the Staff, in a series of no-action letters, has interpreted it to mean for purposes of Section 3(c)(5) that at least 55 percent of the issuer's assets are attributable to that activity (assets that are attributable to a qualifying activity are referred to as Qualifying Interests).[27] Section 3(c)(5)(A) and Section 3(c)(5)(B) except certain financing businesses from the definition of investment company. With respect to 3(c)(5)(A), the Staff has indicated that the exception is available to entities holding a range of Qualifying Interests, including leases relating to equipment,[28] open accounts receivable,[29] fee receivables for motel and hotel franchise rights,[30] airline receivables,[31] bankers' acceptances relating to merchandise or services,[32] promissory notes relating to merchandise,[33] notes representing student loans,[34] notes based on payment for energy and related services,[35] and certain royalty receivables.[36] With respect to 3(c)(5)(B), the Staff's interpretations generally have focused on financing offered directly by distributors of products or services to their customers upon sale. In this context, the Staff has granted relief involving financing of retail grocers' facilities improvements,[37] tractor dealers' equipment sales,[38] farm products,[39] energy services,[40] franchise fee receivables,[41] credit card receivables[42] and educational services,[43] but the Staff

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has denied relief to issuers holding general purpose commercial loans.[44] The crux of the Staff guidance, which generally has been issued via no-action letters, has been whether the receivables held or loans made by the issuer are attributable to specified merchandise, insurance or services.[45] It is therefore important to have a clear understanding of a Transaction Entity's business and its holdings in order to opine whether it may be eligible to rely on these exclusions.

Real Estate Interests—3(c)(5)(C)

According to Staff positions expressed in a series of no action letters, in order to be primarily engaged in "purchasing or otherwise acquiring mortgages and other liens on and interests in real estate," an issuer must satisfy two tests: (1) 55 percent of the issuer's assets must be invested in Qualifying Interests (described below), and (2) an additional 25 percent of the issuer's assets must be invested in "real estate-related" interests (Real Estate-Related Interests) (subject to a reduction to the extent that the issuer invests more than 55 percent of its total assets in Qualifying Interests). The net effect of these requirements is that an issuer relying on Section 3(c)(5)(C) may have no more than 20 percent of its total assets held in investments that are neither Qualifying Interests nor Real Estate-Related Interests.[46]

The determination of whether a particular asset may be a Qualifying Interest or Real Estate-Related Interest under Section 3(c)(5)(C) requires a fact intensive analysis of the particular characteristics of the asset. The Staff generally has taken the position that Qualifying Interests for purposes of Section 3(c)(5)(C) are assets that represent an actual interest in real estate or are loans or liens fully secured by real estate. The Staff has granted no-action relief to the effect that the following types of interests, among others, generally represent Qualifying Interests:

1. Fee interests in real estate;[47]
2. Mortgage loans fully secured by real property;[48]
3. Notes fully secured by a pool of whole mortgage loans;[49]
4. Agency whole pool certificates (that is, known as "whole-pool" GNMAs, FNMAs or FHLMCs) provided that they provide the holder with the same economic experience as an investor who purchases the underlying mortgages directly;[50]
5. Second mortgages secured by real property;[51]
6. Condominium and cooperative housing loans;[52]
7. Deeds of trust on real property;[53]
8. Industrial development bonds primarily secured by mortgage loans;[54]
9. Leasehold interests secured solely by real property;[55]
10. An asset that can be viewed as being the functional equivalent of, and that provides its holder with the same economic experience as, a direct investment in real estate or in a loan or lien fully secured by real estate.[56]

Neither the SEC nor the Staff has defined Real Estate-Related Interests, which is generally a broader category than Qualifying Interests, but the Staff has stated that certain instruments, such as those listed below, would qualify.

1. Mortgage loan secured by other assets in addition to real estate, so long as the value of the real estate is at least 55 percent of the total collateral value;[57]
2. Agency partial pool certificates (certificates issued or guaranteed by agencies such as Freddie Mac or Fannie Mae representing less than the entire ownership interest in a pool of mortgages);[58]
3. Interests in securities backed by mortgages or other interests in real estate;[59]
4. Interests in companies that invest in mortgages or other interests in real estate;[60]
5. Unsecured loans made to developers of real estate interests;[61] and
6. Options and other rights to acquire equity interests in developers of real estate interests.[62]

A Transaction Entity relying on Section 3(c)(5)(C) should carefully review and monitor its portfolio to determine whether it satisfies the

applicable percentage tests to meet the "primarily engaged" requirement. While the Staff has taken the position in the past that an issuer may continue to rely on Section 3(c)(5)(C) if it temporarily does not satisfy the percentage tests, this position was limited to circumstances in which the issuer (i) failed to comply as a result of receiving additional cash, such as from offering additional securities in the issuer or from the sale of assets, and (ii) intended to liquidate or to use the cash to purchase additional assets that would otherwise qualify as soon as possible, but generally within one year.[63]

Subsidiaries—Section 3(c)(6)

As noted above, opinions and representations are often required to address multiple Transaction Entities. Because many Transaction Entities exist only as a form of tax or liability blocker that hold all (or substantially all) of their assets in an issuer that relies on an exception under Section 3(c), certain of these intermediate entities may be able to rely on the exclusion under Section 3(c)(6) when they would otherwise be deemed to hold 100 percent of their assets in investment securities. In relevant part, Section 3(c)(6) excludes from the definition of investment company:

> Any company primarily engaged, directly or through majority-owned subsidiaries, in one or more of the businesses described in [Sections 3(c)(3)-(5)],[64] or in one or more of such businesses (from which not less than 25 per centum of such company's gross income during its last fiscal year was derived) together with an additional business or businesses other than investing, reinvesting, owning, holding, or trading in securities.

Section 3(c)(6) provides an exception for companies that may have multiple lines of business, or operate through various subsidiaries, where, without an exclusion, such activity would cause them to meet the Section 3(a) definition of investment company. Importantly, where a Transaction Entity has multiple lines of business that would fall within Sections 3(c)(3)–3(c)(5), the entity can only claim Section 3(c)(6)'s exception if at least 25 percent of its gross income during its most recent fiscal year is derived from at least one of the businesses described in Sections 3(c)(3), 3(c)(4) or 3(c)(5), and it is not otherwise engaged in the business of investing, reinvesting, owning, holding or trading in securities.[65] For example, where a Transaction Entity derives 23 percent of its gross revenue from leases relating to equipment (a 3(c)(5)(A) Qualifying Interest) and 24 percent of its gross revenue from receivables financings (a 3(c)(5)(B) Qualifying Interest), it would not be eligible for the Section 3(c)(6) exception, but where 26 percent of its gross revenue came from leases relating to equipment, it would be.

Transient Investment Companies—Rule 3a-2

In addition to requiring an opinion that a Transaction Entity is not, or is not required to register as, an investment company within the meaning of the 1940 Act, counterparties often require the issuer to make ongoing representations or covenants to this effect. While a legal opinion provides some comfort as of a particular date in connection with the closing of a transaction, the issuer often nevertheless is required to maintain its exception or exemption from registration as an investment company as an ongoing contractual matter. Rule 3a-2 under the 1940 Act may provide some relief from an issuer's foot-faults in certain limited circumstances. The rule provides that an issuer that meets the definition of investment company in Sections 3(a)(1)(A) or 3(a)(1)(C) is nevertheless excluded from being an investment company for a period of time not to exceed one year; provided that such issuer "has a *bona fide* intent to be engaged primarily, as soon as is reasonably possible," in a non-investment company business. The rule is intended to provide a safe harbor for "transient investment companies" that trip over the

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40 percent threshold found in Section 3(a)(1)(C) for a short period of time due to a temporary or unusual corporate event, so long as they intend to engage in a non-investment company business.

Whether an issuer has the requisite intent to be engaged primarily in a noninvestment company business is based on the facts and circumstances of a particular situation. Rule 3a-2 requires that such intent be evidenced by the issuer's business activities and the passing of an appropriate resolution of the issuer's board of directors (or similar governing body).

The one-year grace period commences "on the earlier of (1) the date on which an issuer owns securities and/or cash having a value exceeding 50 percent of the value of such issuer's total assets on either a consolidated or unconsolidated basis or (2) the date on which an issuer owns or proposes to acquire investment securities having a value exceeding 40 per centum of the value of such issuer's total assets (exclusive of Government securities and cash items) on an unconsolidated basis."[66] Although on several occasions, the Staff has issued no-action letters permitting a transient investment company to rely on the safe harbor for a period longer than one year.[67] The rule does not permit an issuer to rely on its safe harbor more than once during any three-year period.

Conclusion

Transactional activity may bring to light investment company status issues. Because of the weight of the consequences of operating as an inadvertent investment company, it is wise for issuers and transaction sponsors to be abreast of the pitfalls within the definition of investment company and the various exceptions and exemptions from the definition for which they may be eligible. In the transactional context, it is important to not overlook the wording of representations and covenants being negotiated with counterparties given that small differences in wording can lead to more flexibility for Transaction Entities.

While this article only discusses certain status considerations with a focus on finance and real estate transactions, 1940 Act practitioners are adept at navigating the various definitions and exemptions and exceptions from the definition of investment company, and issuers and transactional lawyers should consult with 1940 Act practitioners in connection with any transaction where 1940 Act language is included in the underlying transaction documents.

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NOTES

1. This article is not an exhaustive discussion of the various exceptions and exemptions to the definition of investment company. For example, we do not address two of the most common and familiar exceptions—Section 3(c)(1) and Section 3(c)(7)—for certain limited private offerings.
2. For example, a non-US investment company may meet Section 3's definition of investment company, but would legally not be required to register unless its US activities required such registration. *See* Goodwin, Procter & Hoar LLP, SEC Staff No-Action Letter (Feb. 28, 1997).
3. The third definition is Section 3(a)(1)(B): an issuer that "is engaged or proposes to engage in the business of issuing face-amount certificates of the installment type, or has been engaged in such business and has any such certificate outstanding." This type of investment company is rarely implicated in the transactional context and as such, we do not discuss it in this article.
4. Section 3(a)(1)(A).
5. Section 3(a)(1)(C).

6 It is unlikely that an entity under consideration would escape the definition of "person," and therefore, in practice, this facet is not often explored.

7 The 1940 Act does not define the terms "issues," "proposes to issue," or "issued" although in the ordinary course where an entity sells or proposes to sell its securities and the entity receives value in return for such sale, we treat the entity as having issued the security.

8 A "security" is "any note, stock, treasury stock, security future, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security (including a certificate of deposit) or on any group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a 'security', or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing."

9 *See, e.g.*, Bank of Am. Canada, SEC Staff No-Action Letter (July 25, 1983); Putnam Diversified Premium Income Tr., SEC Staff No-Action Letter (July 10, 1989). In Bank of America Canada, the Staff indicated that, even where an instrument may not be a security for purposes of the 1933 Act and 1934 Act, such a determination is "not applicable in determining whether a person engaged in the business of investing in such notes is investing in 'securities' in the context of a determination of whether the person is an investment company under the 1940 Act" and that, when making a determination that an instrument is a security for 1940 Act purposes, it was necessary to consider that "the relevant 'context' of . . . [the 1940] Act is the regulation of the management of a portfolio of securities . . . ." In Putnam, the Staff concluded that loan participations should be treated as securities for 1940 Act purposes in the context of being held in the portfolio of an investment company, even though these instruments may not be securities under the 1933 Act and 1934 Act. In granting the requested relief, the Staff acknowledged the requesting party's argument that the instruments in question "possess risk attributes that 'strongly suggest' that they be treated as a securities . . . ."

10 SEC v. W.J. Howey Co., 328 U.S. 293 (1946); *see, e.g.*, Pacesetter I L.P., SEC Staff No-Action Letter (July 18, 1986). *See also* Colony Realty Partners 1986, L.P., SEC Staff No-Action Letter (Apr. 27, 1988) (Colony); Oppenheimer Capital, SEC Staff No-Action Letter (July 29, 1987) (Oppenheimer); FCA Realty Fund, SEC Staff No-Action Letter (Nov. 13, 1984) (FCA Realty); Zlotnick, SEC Staff No-Action Letter (June 9, 1986) (Zlotnick).

11 Section 3(a)(1)(A) also picks up an issuer that is "engaged primarily" in investment company business. The analysis of whether an issuer is "engaged primarily" in investment company business is based on the specific facts and circumstances of the issuer and a multi-factor test first enumerated in re Tonopah Mining Co. of Nevada 26 S.E.C. 426, 1947 WL 26116 (July 21, 1947) and issuers typically refer to the more brightline assets and income test in Section 3(a)(1)(C).

12 Section 2(a)(16) of the 1940 Act defines "government securities" to include any security issued or guaranteed as to principal or interest by the United States, or a person controlled or supervised by or acting as an instrumentality of the US government, or any certificate of deposit for the foregoing. The Staff generally considers obligations and certificates of the Government National Mortgage Association, Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation to be government securities. *See, e.g.*, Fed. Nat'l Mortg. Ass'n, 1971 SEC No-Act. LEXIS 1048 (May 6, 1971); Fin. Funding Grp., Inc., 1982 SEC No-Act. LEXIS 2155

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(Mar. 3, 1982); Federal Nat'l Mortgage Ass'n, SEC No-Act. (May 25, 1988) (confirming that FNMA is considered an "instrumentality" of the US government). *See also* Fed. Nat'l Mortg. Ass'n, 2002 SEC No-Act. LEXIS 661 (July 12, 2002); Fed. Home Loan Mortg. Corp., 2002 SEC No-Act. LEXIS 637 (July 12, 2002).

13 Section 2(a)(24) of the 1940 Act defines a "majority-owned subsidiary" of a person as: "[a] company 50 per centum or more of the outstanding voting securities of which are owned by such person, or by a company which, within the meaning of this paragraph, is a majority-owned subsidiary of such person."

14 *See, e.g.*, Hearings on S. 3580, A Bill to Provide for the Registration and Regulation of Investment Companies and Investment Advisers, and for Other Purposes, Before the Subcomm. on Secs. & Exch. of the S. Comm. on Banking & Currency, 76th Cong. 177 (3d Sess.) (1940) (statement of David Schenker, Chief Counsel to the Investment Trust Study) ("We are not even remotely interested in holding companies"). Several other provisions of the 1940 Act exclude bonafide holding companies from regulation under the 1940 Act. *See, e.g.*, Section 3(b)(1) and Section 3(b)(2).

15 The Staff has explained that Section 3(a)(1)(C) "requires unconsolidated financial statements presumably because consolidation of an issuer with a subsidiary which is majority-owned, but not wholly-owned, would distort the relative value of the issuer's investment securities to its other assets. This distortion would occur since consolidation requires all the subsidiary's assets to be included on the issuer's balance sheet." *Certain Prima Facie Inv. Cos.*, Release No. 10,937, 44 Fed. Reg. 66,608, 66,609 n.5 (Nov. 20, 1979) (Rule 3a-1 Adopting Release).

16 Although Rule 3a-1 provides a safe harbor from Section 3(a)(1)(C), it does not provide a safe harbor from Section 3(a)(1)(A). Therefore, even where an issuer meets the requirements enumerated above, if the issuer otherwise satisfies the "holding out" and "engaged primarily" tests under Section 3(a)(1)(A), it will be considered an investment company.

17 Although this term is not defined in the rule itself, in the release proposing Rule 3a-l, the SEC stated that "[s]pecial situation investment companies are companies which secure control of other companies primarily for the purpose of making a profit in the sale of the controlled company's securities." *See* Rule 3a-1 Adopting Release, *supra* n.15, at 66,610.

18 Section 2(a)(9) of the Act provides that a person is presumed to control a company if such person owns more than 25 percent of the voting securities of such company.

19 Health Commc'ns Servs. Inc., SEC Staff No-Action Letter (Apr. 26, 1985). The Staff has said that an evaluation of primary control depends on an examination of the relevant facts. A company "controlled primarily" by the issuer is a company in which the issuer owns more than 25 percent of the voting power and controls more than any other shareholder's voting power. ("In our view, a company is not 'controlled primarily' by an issuer within the meaning of the rule unless (1) the issuer has control over the company within the meaning of Section 2(a)(9) of the 1940 Act, and (2) the degree of the issuer's control is greater than that of any other person.") *Id.*

20 DRX, Inc., SEC Staff No-Action Letter (June 28, 1988). The Staff stated that "[t]he mere existence of a net loss does not eliminate the importance of determining whether a company's activities are primarily related to investing in securities or operating a business."

21 Section 2(a)(43) defines a wholly owned subsidiary of a person as a company 95 per centum or more of the outstanding voting securities of which are owned by such person, or by a company which, within the meaning of Section 2(a)(43), is a wholly owned subsidiary of such person.

22 Notwithstanding this broad exemption, for certain specifically identified provisions of the 1940 Act, specifically Section 12(d)(1)(A)(i) and (B)(i), certain Section 3(c) companies are treated as investment companies. *See, e.g.*, Section 3(c)(7)(D) of the 1940 Act.

[23] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, sec. 619, § 13, 124 Stat. 1376, 1620-31 (2010) (codified as amended at 12 U.S.C. § 1851).

[24] 12 C.F.R. § 248.10(b)(1)(i) (2014). The definition of "covered fund" also includes certain covered commodity pools and certain foreign pooled investment funds.

[25] *See* Section 2(a)(32) of the 1940 Act.

[26] The Staff has stated that each of the following are *not* redeemable securities: (1) a security redeemable at the option of anyone other than the holder; (2) a security redeemable only where the issuer has sufficient liquid assets available; (3) a security entitling the holder to only receive book value; and (4) a partner's limited rights to withdraw from a partnership. *See*, *e.g.,* U.S. Prop. Inv., N.V., 1989 SEC No-Act. LEXIS 641 (May 1, 1989); Prudential Mortg. Bankers & Inv. Corp., SEC Staff No-Action Letter (Dec. 4, 1977); Glendale Inv. Corp., SEC Staff No-Action Letter (Oct. 13, 1976); Arthur D. Little, Inc., SEC Staff No-Action Letter [1971–1972 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶78,365 (Dec. 16, 1971); Cal. Dentists Guild Real Est. Mortg. Fund II, 1990 SEC No-Act. LEXIS 39 (Jan. 4, 1990); Redwood Mortg. Invs. VII, 1990 SEC No-Act. LEXIS 33 (Jan. 5, 1990). The Staff has stated that each of the following *are* redeemable securities: (1) a security that is redeemable but only with 30 days' notice; and a security redeemable by a third party acting for the holder. *See, e.g.*, G.A.B.E., Inc., SEC Staff No-Action Letter [1973–1974 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶79,740 (Mar. 15, 1974); Harvest Real Est. Variable Annuity Acct., SEC Staff No-Action Letter (Oct. 22, 1982).

[27] *See*, *e.g.*, B.C. Ziegler & Co., SEC Staff No-Action Letter (Sept. 11, 1991).

[28] *See* Woodside Grp., 1982 SEC No-Act. LEXIS 2362 (Apr. 14, 1982).

[29] *See* MBCH, Inc., SEC Staff No-Action Letter (Dec. 16, 1981).

[30] *See* Days Inn of Am., Inc., 1988 SEC No-Act. LEXIS 1737 (Dec. 30, 1988); Econo Lodges of Am., Inc., 1989 SEC No-Act. LEXIS 1252 (Dec. 22, 1989).

[31] *See* Ambassador Cap. Corp., 1986 SEC No-Act. LEXIS 2768 (Oct. 6, 1986).

[32] *See* Sterling Franc Inv. & Fin., 1985 SEC No-Act. LEXIS 2216 (Apr. 26, 1985); S.S. Programs, Ltd., 1974 SEC No-Act. LEXIS 599 (Oct. 17, 1974).

[33] *See* Union Tr. Co., SEC Staff No-Action Letter, [1971–1972 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶78,570 (Nov. 26, 1971). *See also* Islamic Republic of Pakistan, 1989 SEC No-Action Letter, LEXIS 78 (Jan. 18, 1989); Days Inn, *supra* n.30; State of New Jersey, SEC No-Act. [1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶77,663 (Apr. 20, 1984); Imperial Bank, 1982 SEC No-Act. LEXIS 3171 (Dec. 15, 1982).

[34] *See* New Eng. Ed. Loan Mktg. Corp., 1998 SEC No-Act. LEXIS 607 (May 22, 1998).

[35] *See* Hannon Armstrong Sustainable Infrastructure Cap., Inc., SEC No-Act. (Sept. 29, 2016).

[36] *See* Royalty Pharma, SEC Staff No-Action Letter (Aug. 13, 2010).

[37] *See* Crescent Cap. Corp., 1980 SEC No-Act. LEXIS 3817 (Oct. 3, 1980).

[38] *See* Coop. Ass'n of Tractor Dealers, Inc., 1981 SEC No-Act. LEXIS 3710 (June 22, 1981).

[39] *See* Union Tr., *supra* n.33.

[40] *See* Hannon Armstrong, *supra* n.35.

[41] *See, e.g.*, Econo Lodges, *supra* n.30; Days Inn, *supra* n.30.

[42] Ambassador Cap., *supra* n.31.

[43] *See* New Ed. Loan Mktg., *supra* n.34.

[44] *See, e.g.*, MESBIC, Inc., SEC Staff No-Action Letter (June 21, 1979); World Evangelical Dev. Ltd, SEC Staff No-Action Letter (Apr. 5, 1979).

[45] *See* Raymond James & Assocs., Inc., SEC Staff No-Action Letter (July 14, 1988) (Denying no-action relief where the company proposed acquiring options on capital equipment on the basis that the option did not constitute an obligation which arises from the sale of the equipment); World Evangelical Dev., *supra* n.44 (denying no-action relief on the basis that the company would not be engaged in sales financing even where the company's loans were secured by the same kind of collateral as may secure sales financing loans).

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[46] *See, e.g.*, Ambassador Cap., *supra* n.31; Citytrust, SEC Staff No-Action Letter (Dec. 19, 1990) (Citytrust); United Bankers, Inc., SEC Staff No-Action Letter (Mar. 23, 1988) (United Bankers).

[47] *See* United Bankers, *supra* n.46.

[48] *See* U.S. Prop. Inv., *supra* n.26.

[49] *See* Premier Mortg. Corp., SEC Staff No-Action Letter (Mar. 14, 1983).

[50] *See* SEC, Div. of Inv. Mgmt., Report 1504, Protecting Investors: A Half Century of Investment Company Regulation, at 72 (1992) (Protecting Investors Study). In contrast, so-called partial pool certificates, which are certificates representing less than the entire ownership interest in a particular pool of mortgages, have not qualified as Qualifying Interests (but would qualify as Real Estate-Related Interests). *See* United Bankers, *supra* n.46.

[51] *See* Prudential Mortg. Bankers & Inv. Corp., SEC Staff No-Action Letter (Dec. 4, 1977); State St. Mortg. Co., SEC Staff No-Action Letter (July 17, 1986); Great Ajax Funding, LLC No-Action Letter (Feb. 12, 2018).

[52] *See* Greenwich Cap. Acceptance, Inc., SEC Staff No-Action Letter (Aug. 8, 1991).

[53] *See* Great Ajax Funding, LLC, SEC Staff No-Action Letter (Feb. 12, 2018).

[54] *See, e.g.*, Citytrust, *supra* n.46; La Quinta Motor Inns, Inc., SEC Staff No-Action Letter (Jan. 4, 1989).

[55] *See* Health Facility Credit Corp., SEC Staff No-Action Letter (Feb. 6, 1985); Great Ajax Funding, *supra* n.53.

[56] *See* Cap. Tr. Inc., SEC Staff No-Action Letter (May 24, 2007) (a Tier 1 mezzanine loan under certain conditions may be considered to be a qualifying interest where the loan can be viewed as being the functional equivalent of, and provide its holder with the same economic experience as, a second mortgage which is a qualifying interest for purposes of Section 3(c)(5)(C)). Note also that the Staff has provided some guidance on when an investment through a multi-tiered structure, such as through a joint venture or partnership that itself invests in real estate, may or may not constitute a Qualifying Interest. We have not addressed such matters herein.

[57] *See* Citytrust, *supra* n.46.

[58] *See* Protecting Investors Study, *supra* n.50, at 73.

[59] *See id.*

[60] *See id.*

[61] *See* Prudential-Bache Sec., Inc., SEC Staff No-Action Letter (Aug. 19, 1985).

[62] *See id.*

[63] *See* Redwood Tr., Inc., SEC Staff No-Action Letter (Aug. 15, 2019); Medidentic Mortg. Invs., SEC Staff No-Action Letter (May 23, 1984).

[64] In summary, 3(c)(3) applies to banks, insurance companies, savings and loans, and other financial institutions and 3(c)(4) applies to small loan companies.

[65] *See* Section 3(c)(6) of the 1940 Act.

[66] *See, e.g.*, In re Comcast Cablevision of Phila., Inc., Order Pursuant to Section 6(C) of The Act Granting Exemption From All Provisions of The Act, Rel. No. 13985 (June 12, 1984).

[67] *See, e.g.*, Mo. River Gold & Gem Corp., SEC Staff No-Action Letter (June 30, 1986) (allowing for an extended period due to particularly complex merger negotiations); Cooper Dev. Co., SEC Staff No-Action Letter (Dec. 12, 1988) (allowing for an extended period where a legitimate business reason, a pending merger, prevented the disposition of certain investment securities).

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