INCOMING LETTER:

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VIA HAND DELIVERY

Douglas J. Scheidt
Associate Director and Chief Counsel
Office of the Chief Counsel
Division of Investment Management
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-0506

Re: Request for interpretation of "substantial portion" as used in Investment Company Act Rule 3a-6

Dear Mr. Scheidt:

We are writing to you to follow up on our correspondence and telephone conversations with the Staff regarding the Staff's willingness to entertain a request for an interpretation of the term "substantial portion" as used in subsection (b)(2) of Rule 3a-6 ("Rule 3a-6" or the "Rule") under the Investment Company Act of 1940 (the "1940 Act"). As discussed further herein, foreign banks we represent are concerned that it may become increasingly uneconomical for them to comport with current interpretations of what constitutes being engaged substantially in commercial banking activities for purposes of reliance on Rule 3a-6. We believe that this concern is not unique to our clients and applies to foreign banks generally.

Rule 3a-6 excludes a "foreign bank," as defined in the Rule, from the definition of investment company within the meaning of the 1940 Act, and was designed to put

foreign banks on an equal footing with their counterparts organized in the United States when issuing securities in the United States.[1] Our foreign bank clients are concerned that in order to continue to meet the definition of "foreign bank" in Rule 3a-6 and be able to issue securities in the United States without registering under the 1940 Act as an investment company they, unlike domestic banks, could be forced to maintain a higher level of deposits than would otherwise be economically warranted by the relative costs of deposits and alternative sources of funding. As a result, these foreign banks could find themselves on an unequal footing with domestic banks due to the need to comply with the Rule that was intended to promote equality between domestic and foreign banks.

Rule 3a-6

Rule 3a-6 provides that "notwithstanding Section 3(a)(1) or Section 3(a)(3) of the [1940] Act, a foreign bank ... shall not be considered an investment company for purposes of the [1940] Act." For purposes of Rule 3a-6, the term "foreign bank" is defined to mean:

> "[a] banking institution incorporated or organized under the laws of a country other than the United States, or a political subdivision of a country other than the United States, that is:
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> (a) regulated as such by that country's or subdivision's government or any agency thereof;
> (b) engaged substantially in commercial banking activity; and
> (c) not operated for the purpose of evading the provisions of the [1940] Act."[2]

"Engaged substantially in commercial banking activity" is defined to mean "engaged regularly in, and deriving a substantial portion of its business from, extending commercial and other types of credit, and accepting demand and other types of deposits, that are customary for commercial banks in the country in which the head office of the banking institution is located."[3]

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1 Investment Company Act Release No. 17682 (August 17, 1990).

2 Rule 3a-6(b)(1).

3 Rule 3a-6(b)(2).

The Securities and Exchange Commission (the "Commission") stated in the release proposing Rule 3a-6 that the intent behind the Rule was to put foreign banks on an equal footing with banks organized in the United States.[4] Banks organized under the laws of the United States are exempt from the definition of investment company by section 3(c)(3) of the 1940 Act. A bank is defined, in relevant part, in section 2(a)(5) of the 1940 Act as "(A) a depository institution (as defined in section 3 of the Federal Deposit Insurance Act [12 USCS § 1813]) or a branch or agency of a foreign bank (as such terms are defined in section 1(b) of the International Banking Act of 1978 [12 USCS § 3101]), (B) a member bank of the Federal Reserve System, [and] (C) any other banking institution or trust company, whether incorporated or not, doing business under the laws of any State or of the United States, a substantial portion of the business of which consists of receiving deposits or exercising fiduciary powers similar to those permitted to national banks under the authority of the Comptroller of the Currency, and which is supervised and examined by State or Federal authority having supervision over banks, and which is not operated for the purpose of evading the provisions of this title." Domestic banks, as defined by the 1940 Act, were exempted from the definition of investment company because they were already subject to significant regulation and therefore it was not necessary to subject them to the registration requirements of the 1940 Act.

Foreign banks that meet the definition of such in Rule 3a-6 are required to be organized under the laws of a country, or political subdivision of a country, other than the United States, are required to derive a substantial portion of their business from accepting deposits and extending commercial and other types of credit, and are required to be regulated as a bank by that country's or political subdivision's government or an agency thereof.[5] The deposit-taking and credit extension aspects of the Rule's requirements

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[4] Investment Company Act Release No. 17682, *supra* note 1.

[5] Rule 3a-6(b)(1)(i).

insure that through regulation of a foreign bank by its country's government or an agency thereof, the foreign bank would be subject to significant regulation similar to the regulation that applied to banks organized in the United States. Unlike foreign banks, however, only certain banks organized in the United States are subject under the definition of "bank" in the 1940 Act to a "substantial portion" test applicable to specified activities, including taking deposits, and even those banks need not satisfy the deposit-taking part of the definition if a substantial portion of their business consists of exercising certain fiduciary powers.[6] As a result, unlike a foreign bank, any bank organized under the laws of the United States is able to satisfy the definition of "bank" under the 1940 Act without being subject to a "substantial portion" test applicable to deposit-taking.

Changes in the Nature of Banking Activities

Our foreign banking clients currently meet all the requirements of the definition of "foreign bank" in Rule 3a-6. Each is a bank that takes deposits and extends credit and is regulated as a deposit-taking institution by its country's government or an agency thereof. They are all "engaged substantially in commercial banking activity" and regularly derive a substantial portion of their business from extending commercial and other types of credit and accepting demand and other types of deposits. Our foreign banking clients are not regulated as investment companies in their home jurisdictions. When Rule 3a-6 was adopted in 1991, the nature of the banking industry was different than it is today, and accepting deposits was a larger source of bank funding than it is now. Today, banks rely more heavily than they did previously on such other sources of funding as, commercial paper, certificates of deposit, medium term notes, bankers acceptances, promissory notes and interbank borrowing. In the United States, the shift in sources of bank funding has

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[6] *See* Section 3(c)(3)(C) of the 1940 Act, which states that the definition of bank includes "any other banking institution or trust company … a substantial portion of the business of which consists of receiving deposits or exercising fiduciary powers similar to those permitted to national banks organized under the authority of the Comptroller of the Currency …."

been accelerated by the adoption of the Gramm-Leach-Bliley Act in 1999, the resulting repeal of many of the Glass-Steagall Act restrictions and the consolidation of banks and other financial services firms.

History of the Use of "Substantial" in Rule 3a-6

Rule 3a-6 does not define "substantial." However, it plainly means something less than "principal" or "primary."[7]

> "Rule 3a-6 is descended, largely without change, from former Investment Company Act Rule 6c-9. As originally proposed in 1986, Rule 6c-9 would have defined 'foreign bank' as an entity 'primarily engaged in accepting demand deposits and making commercial loans.' In response to criticism by commentators that this definition was too restrictive, the Commission determined to revise the definition 'so that it imposes no requirements as to the primary activities engaged in by the entity seeking to use the rule.'"[8]

Currently foreign banks relying on Rule 3a-6 to issue securities in the United States without registering as an investment company do so based on opinions of counsel that they are "engaged substantially in banking activity." The securities bar has interpreted the "substantial portion" language in Rule 3a-6(b)(2) as applying to each of its prongs individually (extending credit and accepting deposits) rather than collectively and generally has been comfortable opining that a 20 percent or greater activity level for each prong is sufficient.

Other Interpretations of "Substantial" Under the Federal Securities Laws

There is some guidance in other areas of the securities laws on what percentage might be considered "substantial," but that guidance is inconsistent. For example, substantial is defined in two regulations under the Securities Act of 1933 (the "1933 Act"). Rule 3-16 of Regulation S-X uses a 20 percent threshold in its definition of "substantial portion of

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[7] Safra Republic Holdings, S.A., SEC No-Action Letter (pub. avail. April 21, 1998).

[8] *Id.*

collateral."[9] Rule 902 of Regulation S also uses the 20 percent threshold in its definition of "substantial U.S. market interest."[10]

In a line of no-action letters concerning reorganizations relying on the exemption in Section 3(a)(10) of the 1933 Act, the Commission permitted resales of the securities issued pursuant to the exemption without compliance with the registration provisions of the 1933 Act when the sellers of the securities did not receive a substantial amount of the securities. In these letters, substantial amount was generally considered to be greater than one percent.[11] In a pair of earlier 3(a)(10) letters, the Commission declined to define what constituted a "substantial amount of debentures," but it agreed not to recommend enforcement action based on an opinion of counsel that "10 percent or less of the debentures would not represent an amount which is substantial in relation to the amount of debentures issued."[12] In *Guides for Preparation and Filing of Registration Statements*, the Commission used the 10 percent threshold when it defined a "substantial amount of securities to be offered in relation to the securities of the class outstanding."[13] In the

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[9] Rule 3-16 of Regulation S-X defines "substantial portion of collateral" to be where "the aggregate principal amount, par value, or book value of the securities as carried by the registrant, or the market value of such securities, whichever is the greatest, equals 20 percent or more of the principal amount of the secured class of securities."

[10] "Substantial U.S. market interest" for a class of foreign equity securities is defined, in relevant part, to be where "20 percent or more of all trading in the class of securities took place in, on or through the facilities of securities exchanges and inter-dealer quotation systems in the United States and less than 55 percent of such trading took place in, on or through the facilities of securities markets of a single foreign country in the shorter of the issuer's prior fiscal year or the period since the issuer's incorporation." Regulation S, Rule 902(j)(1). In the adopting release, the Commission responded to commentators' concerns that defining substantial U.S. market interest using percentages would present difficulties where records of trading in an issuer's equity securities were inaccessible or incomplete by stating that in such cases "the issuer may reasonably believe there is not a substantial U.S. market interest in that class of securities where less than 20 percent of the class is held by persons for whom a U.S. address appears on the records. …" Investment Company Act Release No. 17458 (April 24, 1990). Rule 902 also uses the 20 percent test in defining "substantial U.S. market interest" in debt securities. Regulation S, Rule 902(j)(2).

[11] *See e.g.* Stampede Int'l Resources Ltd, Northwest Ventures (pub. avail. January 4, 1982), HRS Ind. Inc. (pub. avail. April 1, 1982), International H.R.S. Ind., Inc. (pub. avail. April 16, 1984) and Dreco Energy Services Ltd. & Dreco, Inc. (pub. avail. December 31, 1984).

[12] April Industries, Inc. (pub. avail. April 14, 1977 and March 18, 1977).

[13] Securities Act Release No. 4936 (December 9, 1968).

proposing release for Rule 203A-3 under the Investment Advisers Act of 1940, "investment adviser representative" was proposed to include "only those supervised persons a 'substantial portion' of whose business is providing advice to natural persons." Here, a 10 percent threshold was used in the definition of "substantial portion."[14] In a concept release on takeovers and contests for corporate control in which the Commission outlined a possible approach to applying the protections of the Williams Act to substantial acquisitions undertaken during or shortly after tender offers, the Commission suggested that a "substantial amount of target company securities" might be 10 percent.[15] Certain of the self-regulatory organizations have used a five percent threshold in their interpretations of "substantial." For example, the New York Stock Exchange defines a "substantial security holder" to be one who holds five percent of either a company's stock or voting power.[16] In a proposed rule on hot equity offerings, NASD Regulation, Inc. selected a five percent threshold premium in its definition of hot issue, stating that it preliminarily believed (subject to comment) that "a 5 percent premium effectively

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[14] Investment Advisers Act Release No. 1601 (December 20, 1996). The Commission proposed that "a substantial portion of a supervised person's business would be providing advice to natural persons if, during the preceding twelve months, more than ten percent of the supervised person's clients consisted of natural persons, or more than ten percent of the assets under management by the adviser attributable to the supervised person were assets of clients who are natural persons " (the 10 percent allowance). *Id.* The rule as adopted did not reference "substantial portion"; however, the 10 percent allowance was adopted substantially as proposed. Investment Advisers Act Release No. 1632 (May 9, 1997).

[15] Securities Exchange Act Release No. 23486 (July 31, 1986). The Commission specifically requested comment on the need for and appropriate level of the threshold. *Id.* The Commission subsequently proposed Rule 13e-2 with the 10 percent threshold. Securities Exchange Act Release No. 24976 (October 1, 1987). The proposal was later withdrawn.

[16] *See*, Securities Act Release No. 39098 (September 19, 1997) ("Issuers sometimes seek cash financing from one or more of their "substantial" security holders (which the Exchange defines as a person holding either five percent of the company's stock or five percent of the company's voting power")). *See also*, Section 312.04 of the New York Stock Exchange Listed Company Manual ("[A]n interest consisting of less than either five percent of the number of shares of common stock or five percent of the voting power outstanding of a company or entity shall not be considered a substantial interest or cause the holder of such an interest to be regarded as a substantial security holder").

distinguishes between offerings for which there is substantial excess investor demand and those that are generally satiated by the market supply."[17]

Interpretation of "Substantial" Under the Federal Reserve Act

Since the purpose of Rule 3a-6 is to put foreign banks on an equal footing with banks organized in the United States, the federal banking laws also may provide some guidance on an interpretation of "substantial." An interpretation of "substantial" can be found in Federal Reserve Board Rulings regarding Section 20 of the Glass-Steagall Act ("Section 20"). Section 20, which was repealed by the Gramm-Leach-Bliley Act, provided that a member bank of the Federal Reserve System could not be affiliated with a company that was "engaged principally" in underwriting and dealing in securities.[18] In 1987, the Federal Reserve Board (the "Board") first interpreted the term "engaged principally." At that time the Board determined that "principal" included definitions such as "primary," "substantial," "leading," "important," or "outstanding" and translated into a stricter limitation on underwriting and dealing than "main" or "largest" (therefore somewhat lower than 49 percent).[19] The Board then translated this interpretation into a quantitative limit on the amount of gross revenue allowable from underwriting and dealing.[20] The Board determined that "underwriting and dealing in bank-ineligible securities (the only securities that counted toward the Section 20 limit) would not be a 'substantial' activity for a Section 20 subsidiary if the gross revenue derived from that activity did not exceed 5 to 10 percent of the total gross revenue of the subsidiary."[21]

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[17] Securities Exchange Act Release No. 42325 (January 10, 2000). NASD Regulation, Inc. subsequently decided against any threshold for a blanket prohibition and revoked the threshold in an amended proposal. Securities Exchange Act Release No. 43627 (November 28, 2000).

[18] Revenue Limit on Bank-Ineligible Activities of Subsidiaries of Bank Holding Companies Engaged in Underwriting and Dealing in Securities, 61 Fed. Reg. 68750 (December 30, 1996), citing 12 U.S.C. 377.

[19] *Id.*

[20] *Id.*

[21] *Id.* The Board initially limited ineligible revenue to five percent of total revenue in order to gain experience supervising such subsidiaries. In 1989, the Board increased the limit to 10 percent. *Id.*

In 1996, the Board proposed to increase the limit on gross revenue derived from underwriting and dealing in bank-ineligible securities to 25 percent. The Board stated its belief that the 10 percent limitation unduly restricted the underwriting and dealing activity of Section 20 subsidiaries, especially since changes in the product mix that they were permitted to offer and developments in the securities markets had changed the relationship between gross revenue and underwriting and dealing activity from the relationship that prevailed in 1987.[22] The Board concluded that 10 percent was an unduly restrictive limit for defining the level of activities that would not amount to a "principal engagement" for purposes of Section 20. The Board based this conclusion on its experience supervising and examining Section 20 subsidiaries and on "identifiable changes in the relationship between gross revenue and underwriting and dealing" since 1987.[23] Finally, the Board agreed with commentators who "stressed that an increase in the revenue limit would allow Section 20 subsidiaries to operate more efficiently and compete more effectively domestically and globally and would benefit both institutional and individual customers by increasing customer choice and lowering prices."[24]

Suggested Interpretations of "Substantial Portion"

While the Commission did not suggest what a "substantial portion" of deposits might be, in the release adopting Rule 3a-6, the Commission was clear that it intended to require a foreign bank to accept some amount of deposits in the definition of "foreign bank."[25] The Commission rejected comments urging the Commission to adopt a broader definition

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22 *Id*. The Board believed that this change resulted, in part, from the circumstance that in 1989 the levels of gross revenue and underwriting and dealing included activity involving corporate debt and other securities first approved by the Board in 1989 as bank-eligible securities, whereas in 1987 bank-eligible securities, and therefore underwriting and dealing activities, were limited to commercial paper, municipal revenue bonds, mortgage-backed securities, and consumer-receivable-related securities.

23 *Id*.

24 *Id.*

25 Investment Company Act Release No. 18381 (October 29, 1991).

in the Rule that would include banks that "provided many traditional banking services, but [did] not accept deposits."[26] The Commission believed that such a broad definition of "foreign bank" would "bring within the scope of the rule entities that would not be banks under the 1940 Act if those entities were organized under the laws of the United States, and thus would not accord with the principal purpose of Rule 3a-6, which is to put foreign banks selling securities in the United States on an equal footing under the [1940] Act with banks organized under the laws of the United States."[27] While there is a question of what amount of deposits is "substantial" for purposes of Rule 3a-6, we believe there is no question about the need for foreign banks to take deposits and be regulated as deposit-taking institutions.

We believe that requiring foreign banks to be subject to the regulatory oversight applicable to deposit-taking institutions is important. However, we believe also that it is not necessary to separately quantify for a foreign bank the amount of deposits being taken as long as some deposits are taken and the bank extends commercial and other types of credit at a level that makes the combination of these two activities a substantial portion of the foreign bank's business. A foreign bank should be able to determine the appropriate mix of credit extensions and deposits based on what is the most economically sound approach to obtaining capital. That the foreign bank is authorized to and engages in deposit-taking and extending credit at whatever level the bank chooses insures that the foreign bank is subject to the type of regulation the Commission seeks, regardless of the level of either activity separately.

Reliance on the type or quality of regulatorily significant activity rather than the quantity of that activity is supported by the decision of the Supreme Court in *Marine Bank v. Weaver*.[28] There, the Supreme Court refused to subject an issuer of a bank certificate of

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[26] *Id.*

[27] *Id.*

[28] 455 U.S. 551 (1982).

deposit insured by the Federal Deposit Insurance Corporation (the "FDIC") to liability under the federal securities laws because holders of bank certificates of deposit are protected by a comprehensive set of regulations governing the banking industry and are abundantly protected under those laws in ways that make application of the federal securities laws unnecessary.[29] In *Brockton Sav. Bank v. Peat, Marwick, Mitchell & Co.*,[30] a case in which the plaintiff brought suit seeking to recover loss on an FDIC insured certificate of deposit under the federal securities laws arguing, among other things, that the certificate of deposit was only partially FDIC insured and that the issuer lent the depositor's funds to risky outside ventures. Interpreting the Supreme Court's decision in *Weaver*, the *Brockton* Court stated that the certificate of deposit was not a security under any test, and even though the certificate of deposit was not fully covered by FDIC insurance and the issuer lent the depositor's funds to risky outside ventures, this did not transform the deposit into an investment protected by the federal securities laws.[31] The Court emphasized that the deposit was "abundantly protected" by the banking laws and remedy must be sought through those laws.[32] The Court in *Brockton* clearly concluded that it was not important how much of the certificate of deposit was covered by the FDIC insurance, rather it was only important that the issuing bank was thoroughly regulated. We believe that this rationale is applicable here.

Although arguments can be made for having no thresholds in order to provide parity of treatment between domestic and foreign banks, we believe it is appropriate to use either a numeric threshold requirement to establish a meaningful basis for regulation-invoking activities or non-numeric qualitative indicia of those activities.

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29 *Id.* at 558.

30 577 F. Supp. 1281 (1983).

31 *Id.*

32 *Id.*

In our view, the appropriate numeric threshold for purposes of Rule 3a-6 should be 10 percent and should relate to deposit-taking and credit extension in the aggregate in order to provide foreign banks maximum economic flexibility.[33] To provide this flexibility we suggest requiring that the average of the separate percentages obtained by computing (i) credit extension revenues as a percentage of the foreign bank's revenues, (ii) receivables from credit activities as a percentage of the foreign bank's assets and (iii) deposits as a percentage of the foreign bank's liabilities be required to exceed 10 percent.

A non-numeric, qualitative approach would be to require a foreign bank (i) to be authorized to accept demand and other types of deposits and to extend commercial and other types of credit, (ii) to hold itself out as engaging in, and to engage in, each of those activities on a regular and continuous basis, including actively soliciting depositors and borrowers, and (iii) to engage in either deposit taking or credit extension as one of the bank's principal activities requiring separate identification in publicly disseminated reports and regulatory filings describing the bank's activities.

Either of the foregoing approaches would ensure that a foreign bank, like its competitor banks organized in the United States, is able to use the most economically advantageous methods for funding itself through the liability side of its balance sheet and that the banking activities in which the foreign bank engages are more than nominal.

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[33] We believe that, as described above, 10 percent has been widely used as a measure of "substantial" under the federal securities laws. We believe also that the Board's determination to increase the threshold on gross revenue derived from underwriting and dealing in bank-ineligible securities from 10 to 25 percent was a regulatory decision regarding the appropriate maximum allowed for activities that had become increasingly significant and not an effort to define "substantial."

Please contact us at (202) 737-8833 if you have any questions about the information that we have provided to you.

Very truly yours,

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cc: Sara P. Crovitz, Senior Counsel

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