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A CASE AGAINST ADMINISTRATIVE RESTRAINT: DECLARATORY STATUS ORDERS UNDER THE INVESTMENT COMPANY ACT OF 1940

Roger W. Kapp† and *Robert M. Hart*‡

The declaratory order has long promised to be a significant administrative resource, offering a flexible and efficient means for administrative agencies to resolve uncertainties within their jurisdiction, thereby promoting prompt and uniform application of the statutes they administer. In a recent decision,¹ the Securities and Exchange Commission declined to entertain a third party's application for a declaratory order determining an issuer's status under the Investment Company Act of 1940, apparently due to the Commission's reservations about the jurisdictional bases for the proceeding and the administrative efficiency of declaratory status orders. This Article examines the Commission's authority and responsibility with respect to declaratory status proceedings under the Investment Company Act of 1940.²

The Investment Company Act of 1940 ("1940 Act"), administered by the Securities and Exchange Commission ("Commission"), creates a comprehensive pattern of regulation for investment companies. The term "investment company" is defined in section 3(a) of the 1940 Act.³ Application of the standards set

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¹ *In re* Loews Corp., application of CNA Financial Corp. (SEC File No. 812-3667), 74 SEC News DIGEST, Oct. 2, 1974, at 1.

² 15 U.S.C. §§ 80a-1 to -52 (1970).

³ 15 U.S.C. § 80a-3(a) of the 1940 Act provides three definitions of the term "investment company": (1) any issuer which "is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading in securities," (*id.* § 80a-3(a)(1)); (2) any issuer which "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," (*id.* § 80a-3(a)(2)); (3) any issuer which "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," (*id.* § 80a-3(a)(3)). The term "investment securities" is defined in § 3(a) to include "all securities except (A) Government securities, (B) securities issued by employees' securities companies, and (C) securities issued by majority-owned subsidiaries of the owner which are not investment companies."

forth therein may require a complex financial analysis and the resolution of many subjective issues.⁴ Moreover, the task of ascertaining an issuer's status as an investment company may be further complicated by consideration of more than twenty specific exemptions and exclusions from investment company status and regulation provided by the 1940 Act.⁵

Determination that an issuer is an investment company brings into operation the registration requirements⁶ and the substantive regulatory provisions of the 1940 Act.⁷ Not surprisingly, substantial uncertainty may exist as to whether a particular issuer is an investment company. The penalties for operating as an unregistered investment company make such uncertainty of more than academic interest.⁸ Yet registration under the 1940 Act may not be totally painless itself, since the regulatory provisions of the 1940 Act, which were designed primarily for the protection of investors in the traditional investment company,⁹ may not be

⁴ See, e.g., *SEC v. Fifth Ave. Coach Lines, Inc.*, 289 F. Supp. 3 (S.D.N.Y. 1968), *aff'd*, 435 F.2d 510 (2d Cir. 1970). For a discussion of the general problems involved in determining investment company status, see Garrett, *When is an Investment Company?*, 37 U. DET. L.J. 355 (1960); Kerr, *The Inadvertent Investment Company: Section 3(a)(3) of the Investment Company Act*, 12 STAN. L. REV. 29 (1959); Kerr and Appelbaum, *Inadvertent Investment Companies—Ten Years After*, 25 BUS. LAW. 887 (1970).

⁵ See 15 U.S.C. §§ 80a-3(b), -3(c), -6 (1970).

⁶ *Id.* § 80a-8.

⁷ The 1940 Act prescribes restrictions on such matters as activities and investments (15 U.S.C. § 80a-12 (1970)) and capitalization (*id.* § 80a-18).

⁸ Section 7 of the 1940 Act (15 U.S.C. § 80a-7 (1970)) prohibits an investment company, unless registered under § 8 of the 1940 Act (*id.* § 80a-8), from offering or selling any of its securities, purchasing any securities, engaging in any business in interstate commerce or controlling any company which is engaged in any business in interstate commerce. Section 42(e) of the 1940 Act (*id.* § 80a-41(e)) provides, *inter alia*, that in any action by the Commission to enforce compliance with § 7, the Commission may request, and the court may appoint, a receiver. Moreover, § 47(b) of the 1940 Act (*id.* § 80a-46(b)) provides that every contract made in violation of the 1940 Act shall be void. Although most of the substantive restrictions of the 1940 Act are specifically applicable to *registered* investment companies, the Commission has consistently maintained that such substantive provisions are equally applicable to unregistered investment companies that ought to be registered. See, e.g., *SEC v. The Carter Group, Inc.*, 74 Civ. 4521 (S.D.N.Y., Nov. 18, 1974) (complaint); *SEC v. S & P Nat'l Corp.*, 360 F.2d 741, 752 n.15 (2d Cir. 1966).

⁹ See *Greater Iowa Corp. v. McLendon*, 378 F.2d 783, 793-94 (8th Cir. 1967).

As noted in § 1(b), the 1940 Act was enacted in response to the numerous abuses reported by the Commission in *SEC Report on Investment Trusts and Investment Companies (1938-40)*. The Commission's Report

found that to an alarming extent investment companies had been operated in the interests of their managers and to the detriment of investors. A high incidence of recklessness and improvidence was also noted. Insiders often viewed investment companies as sources of capital for business ventures of their own and as captive markets for unsalable securities that they, the insiders, wished to convert into cash. Controlling persons frequently took unfair advantage of the companies in other

compatible with the normal activities of an operating company.¹⁰

ways, often using broad exculpatory clauses to insulate them from liability for their wrongdoing. Outright larceny and embezzlement were not uncommon. Managers were able to buy investment company shares for less than net asset value, thus enriching themselves at the shareholders' expense.

In addition, reports to shareholders were often misleading and deceptive. Controlling positions in investment companies—represented by special classes of stock or by advisory contracts—were bought and sold without the consent, or even the knowledge, of public shareholders. Basic investment policies were changed without shareholder approval. The advisory contracts themselves were often long term and either noncancellable or cancellable only upon the payment of a substantial penalty by the company. Sales loads were as high as 20 percent. Management fees charged in connection with contractual plans sometimes bore no relationship to any actual managerial services.

Often only a small portion of the first year's payments in contractual plans were invested in underlying securities for the investor's account. Because of extensive debt financing, fluctuations in the value of portfolio securities had a disproportionately severe effect on the value of investment company shares; highly leveraged capital structures made investment company shares extremely speculative and exposed those who purchased them to extraordinarily high degrees of risk.

SEC, REPORT ON PUBLIC POLICY IMPLICATIONS OF INVESTMENT COMPANY GROWTH, H.R. REP. 2337, 89th Cong., 2d Sess. 64-65 (1966) (footnotes omitted). The 1940 Act seeks to deal with those abuses by providing a comprehensive regulatory framework which imposes substantive restrictions on such matters as the eligibility of affiliated persons and underwriters of investment companies (§ 9), composition of the board of directors (§ 10), permissible investments (§ 12), changes in investment policies and fundamental policies (§ 13), minimum net worth (§ 14(a)), the term and provisions of investment advisory and underwriting contracts (§ 15), transactions with affiliated persons (§ 17), capital structure and indebtedness (§ 18), funds available for dividends (§ 19), solicitation of proxies (§ 20), loans (§ 21), distribution, redemption and repurchase of securities (§§ 22-23), accounts and records (§ 31), the selection of independent auditors (§ 32(a)), and the fiduciary duties of affiliated persons of the investment company (§ 36(b)).

¹⁰ For example, a company with a number of operating subsidiaries or affiliates may have difficulty complying with the provisions of § 17 of the 1940 Act (15 U.S.C. § 80a-17 (1970)). With certain exceptions, § 17(a) prohibits an affiliated person of a registered investment company, acting as principal, to sell any security to such investment company or any company controlled by such investment company; § 17(e) prohibits the affiliate, acting as agent, from accepting compensation for the purchase or sale of any property to or for the investment company or any company controlled by it, except in the course of such affiliate's business as a broker or underwriter; and § 17(d) makes it unlawful for any affiliated person of a registered investment company acting as principal to effect any transaction in which such investment company or any company controlled by it is a joint or joint and several participant with such affiliated person. In particular, transactions between related companies controlled by an investment company, such as subsidiaries of the investment company, are subject to § 17. Some limited exemptions are provided by various Commission Rules. Commission Rule 17a-3, 17 C.F.R. § 270.17a-3 (1974), exempts from § 17(a) transactions solely between an investment company and one or more of its "fully-owned" subsidiaries, and transactions solely between two or more of its "fully-owned" subsidiaries. However, a "fully-owned" subsidiary for the purposes of Rule 17a-3 is a subsidiary all of whose outstanding securities (other than directors' qualifying shares) are owned by the parent and/or the parent's other fully-owned subsidiaries and which is not indebted to any person other than the parent and/or other fully-owned subsidiaries, except indebtedness incurred in the ordinary course of business and maturing within one year, and indebtedness to one or more banks or insurance companies. 17 C.F.R. § 270.17a-3(b) (1974). This narrow definition of a "fully-owned" subsidiary may make Rule 17a-3 of very limited use for most issuers.

Consequently, few operating companies would consciously permit the nature of their activities to change so as to make them investment companies; operating companies that undergo such a change are usually referred to as inadvertent investment companies.¹¹ Nevertheless, the legislative history of the 1940 Act evidences careful consideration of the need for substantive regulation of such inadvertent investment companies and the abuses sought to be prevented thereby.¹²

If an issuer is concerned that it may be considered an investment company, it may in certain circumstances seek a determination by the Commission as to its status pursuant to section 3(b)(2) of the 1940 Act.¹³ Other persons interested in the

Other 1940 Act Rules may provide an exemption in various types of transactions, but these Rules generally relate to very limited situations. An issuer could apply to the Commission for an exemption for any transaction subject to § 17 which is not exempted by a Rule, but since the Commission does not grant "blanket" exemptions from § 17 (Keystone Custodian Funds, Inc., 1940 Act Release No. 820 (Nov. 8, 1945)), a specific exemption would have to be sought for each transaction subject to § 17.

¹¹ See, e.g., Kerr, *supra* note 4, at 30.

¹² S. REP. NO. 1775, 76th Cong., 3d Sess. 6 (1940). As Mr. David Schenker, Chief Counsel of the Commission's Investment Trust Study, testified:

The third subdivision [section 3(a)(3)] is what we call our statistical formula. The definition was based upon a very detailed analysis we made of every corporation which was listed on any exchange in this country. On the basis of our studies and analyses, we devised this formula, which in essence says that if a company has 40 percent of its assets in securities other than securities of its subsidiaries, they are investment companies. Curiously enough . . . this definition has been in circulation since the time of our first report in 1938 and no company, virtually no company, that is not popularly regarded as an investment company, has been caught by this formula, except possibly one . . . and I will discuss that in a moment.

Hearings on H.R. 10065 Before the Subcomm. of the House Comm. on Interstate and Foreign Commerce, 76th Cong., 3d Sess. 101 (1940).

¹³ 15 U.S.C. § 80a-3(b)(2) (1970). Section 3(b) of the 1940 Act (*id.* § 80a-3(b)) is of recurring significance. It provides, in relevant part, that notwithstanding § 3(a)(3) of the 1940 Act,

none of the following persons is an investment company . . . (1) Any issuer primarily engaged, directly or through a wholly-owned subsidiary or subsidiaries, in a business or businesses other than that of investing, reinvesting, owning, holding, or trading in securities. (2) Any issuer which the Commission, upon application by such issuer finds and by order declares to be primarily engaged in a business or businesses other than that of investing, reinvesting, owning, holding, or trading in securities either directly or (A) through majority-owned subsidiaries or (B) through controlled companies conducting similar types of businesses.

Thus, § 3(b)(2) permits an exemptive finding with respect to primary engagement (1) directly, (2) through majority-owned subsidiaries, or (3) through controlled companies conducting similar types of businesses, and an issuer seeking exemption by reason of (2) or (3) must make an application to the Commission. To the extent that § 3(b)(2) authorizes a finding of "direct" engagement, it overlaps the automatic exception of § 3(b)(1). Moreover, to the extent that it may be argued that the term "majority-owned subsidiary" is subsumed within the term "wholly-owned subsidiary," § 3(b)(2) would further overlap § 3(b)(1). Nevertheless, § 3(b)(2) by its literal terms is available only as a procedure for a Commission determination with respect to situations involving § 3(a)(3), and is, therefore, of limited

issuer's possible status as an investment company, such as its shareholders,¹⁴ companies being acquired by the issuer in a tender offer,¹⁵ and the Commission,¹⁶ have sought clarification in the courts.

Recently, however, in the context of a proposed tender offer, a target company applied to the Commission for a declaratory order with respect to the status of the offeror under the 1940 Act.¹⁷ The target company contended in its application that there was a substantial question as to whether the offeror and its subsidiaries were investment companies within the meaning of section 3(a) of the 1940 Act and thus required to register under section 8 of the 1940 Act. The target company further claimed that if the offeror were required to register under the 1940 Act, the proposed tender offer would be prohibited by section 12(d) of the 1940 Act.¹⁸ In declining to entertain the application, the Commission stated that if it did have jurisdiction to entertain the proceeding, such jurisdiction would be discretionary, and it refused to affirmatively exercise that discretion.¹⁹ The Commission also noted that it did

utility for declaratory status determinations. However, it appears that § 3(b)(2) was intended by Congress neither as a means for issuers to obtain security as to their status under the 1940 Act nor as an overlap of § 3(b)(1). Rather, the legislative history of the 1940 Act indicates that § 3(b)(2) contemplates a factual situation different from that covered by § 3(b)(1), about which the issuer would not be permitted to determine its own status. As David Schenker, Chief Counsel of the Commission's Investment Trust Study, testified in the Senate hearings on the 1940 Act:

We say that even if you find that more than 40 percent of the assets of a company are in marketable securities, securities of companies which are not its own subsidiaries, we still say that it cannot be an investment company, within the purview of this legislation if—what? If this company is engaged primarily directly or through wholly owned subsidiaries in a business other than that of investing and reinvesting or trading in securities.

Then we say, further, that even if you may fall prima facie within the statistical formula, if you can prove that even though you do not do your business through wholly owned subsidiaries but through majority-owned subsidiaries, if you make out a case that you are engaged in a business other than investing and reinvesting in securities, you will be exempt.

Hearings on S. 3580 Before a Subcomm. of the Senate Comm. on Banking and Currency, 76th Cong., 3d Sess. 177 (1940).

¹⁴ See, e.g., *Esplin v. Hirschi*, 402 F.2d 94 (10th Cir. 1968), cert. denied, 394 U.S. 928 (1969).

¹⁵ See, e.g., *D-Z Investment Co. v. Hallway*, CCH FED. SEC. L. REP. ¶ 94,771 (S.D.N.Y. 1974).

¹⁶ See, e.g., *SEC v. Fifth Ave. Coach Lines, Inc.*, 289 F. Supp. 3 (S.D.N.Y. 1968), aff'd, 435 F.2d 510 (2d Cir. 1970).

¹⁷ *In re Loews Corp.*, application of CNA Financial Corporation (SEC File No. 812-3667 (1974)), 74 SEC. NEWS DIGEST, Oct. 2, 1974, at 1.

¹⁸ 15 U.S.C. § 80a-12(d) (1970).

¹⁹ Letter from Allan S. Mostoff, Director, Division of Investment Management Regula-

not consider the application an appropriate vehicle for consideration of the issues it raised.

The Commission has expressed doubts in the past about its authority to determine an issuer's status as an investment company in any manner other than that specifically authorized by section 3(b)(2).²⁰ The Commission's continuing reservations about its jurisdiction may foreclose the utility of declaratory status proceedings, whether initiated by third parties, the Commission, or (in many cases) by issuers. Apart from jurisdictional concerns, the Commission's response to the target company's application may simply reflect an unwillingness on the Commission's part to permit third-party-initiated proceedings. For the reasons discussed below, however, the Commission does have ample jurisdiction to grant declaratory orders with respect to an issuer's status under the 1940 Act, and when presented with an application from an issuer or a third party that raises a patently substantial question about an issuer's status as an investment company, the public interest would be served by the exercise of such jurisdiction.

Subject to certain conditions, agencies are authorized by section 5(d) of the Administrative Procedure Act²¹ ("APA") to issue declaratory orders "to terminate a controversy or remove uncertainty." Since the section 3(a) definitions include issuers which propose to engage in the activities described therein, the authorization of section 5(d) may in many cases overlap specific or implied authority under the 1940 Act.²² As discussed later, without attempting to delineate the point at which section 5(d) authority would be necessary to support a 1940 Act proceeding, it may be seen that the Commission has issued declaratory orders not specifically authorized by the 1940 Act under section 5(d) of the APA and/or the general authority granted to the Commission by other

tion, SEC, to CNA Financial Corporation, September 20, 1974 (SEC File No. 812-3667 (1974)).

²⁰ See, e.g., Bankers Securities Corp., 15 S.E.C. 695 (1944); International Mining Corp., 12 S.E.C. 174 (1942).

²¹ 5 U.S.C. § 554(e) (1970). This section was originally § 5(d) of the Administrative Procedure Act, 5 U.S.C. § 1004(d) (1964); however, in 1966 as part of the enactment into law of Title 5 of the United States Code, the Administrative Procedure Act was repealed and its former provisions with amendments were enacted as 5 U.S.C. §§ 551-59, 701-06 (1970). Although there appears to be substantial confusion as to the proper form of citation, 5 U.S.C. § 554(e) is herein cited as § 5(d) of the APA.

²² For example, the §§ 3(a)(1) and 3(a)(3) definitions of "investment company" (see note 3 *supra*) include any company which *proposes* to engage in the specified activities. Although it is not clear that a § 3(b)(2) proceeding (see note 13 *supra*) may be based on purely prospective facts, the Commission has issued completely prospective exemptions pursuant to § 6(c). See note 78 *infra*.

sections of the 1940 Act, and judicial authority affirmatively endorses the existence and exercise of such authority.

The Commission is mandated by Congress, in section 1(b) of the 1940 Act,²³ to administer the 1940 Act so as "to mitigate and, so far as is feasible, to eliminate the conditions enumerated in this section which adversely affect the national public interest and the interest of investors."²⁴ To implement this mandate, Congress has granted the Commission substantial authority. Among its general powers, section 38(a)²⁵ of the 1940 Act provides, in part, that

[t]he Commission shall have authority . . . to make, issue, amend, and rescind such rules and regulations and such orders as are necessary or appropriate to the exercise of the powers conferred upon the Commission elsewhere in this subchapter²⁶

In addition, pursuant to section 6(c) of the 1940 Act²⁷ the Commission "may conditionally or unconditionally exempt any person, security, or transaction, or any class or classes of persons, securities, or transactions, from any provision or provisions of this subchapter"²⁸ The Commission has construed its power under section 6(c) to permit the granting of retroactive as well as prospective exemptions.²⁹ Thus, since the Commission may absolve any person from any provision of the 1940 Act, including any prior violation thereof, the Commission's authority to construe and administer the 1940 Act is, to a substantial extent, final and exclusive.³⁰

Except for section 3(b)(2),³¹ the 1940 Act does not expressly authorize investment company status determinations.³² Nevertheless, absent an express or implied limitation in the 1940 Act, the clear language of section 38(a), when construed consistently with

²³ 15 U.S.C. § 80a-1(b) (1970).

²⁴ *Id.*

²⁵ *Id.* § 80a-37(a).

²⁶ *Id.*

²⁷ *Id.* § 80a-6(c).

²⁸ *Id.*

²⁹ *See, e.g.,* Great Am. Life Underwriters, Inc., 41 S.E.C. 1 (1960); Hugh B. Baker, 24 S.E.C. 202 (1946).

³⁰ This is not to say that the Commission's authority is unregulated. The Commission is authorized under § 6(c) to grant exemptions "if and to the extent that such exemption is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of this subchapter." 15 U.S.C. § 80a-6(c) (1970). Commission determinations in this regard are, of course, subject to judicial review. *Id.* § 80a-42(a).

³¹ *See* note 13 *supra*.

³² The Commission is authorized by § 2(a)(9) of the 1940 Act (15 U.S.C. § 80a-2(a)(9) (1970)) to make determinations of "control."

the judicial decisions involving general grants of power,³³ would provide the Commission with authority, either alone or in conjunction with section 5(d) of the APA, to make such status determinations.

*SEC v. Talley Industries, Inc.*³⁴ is directly relevant. Talley Industries argued that the Commission's Rule 17d-1³⁵ exceeded the authority granted by Congress under section 17(d)³⁶ of the 1940 Act. The United States Court of Appeals for the Second Circuit held, however, that the "issue must be considered in light of the general power conferred on the SEC by section 38(a) . . ."³⁷ After analyzing the legislative history of section 17 of the 1940 Act, Judge Friendly stated that "[w]e thus do not find the legislative history so compelling as to warrant a conclusion that Congress meant to deny the SEC power to utilize a method of regulation it had successfully used in other areas."³⁸ The clear import of the Second Circuit's analysis is that section 38(a) should be construed liberally

³³ See cases cited in note 39 *infra*.

³⁴ 399 F.2d 396 (2d Cir. 1968), *cert. denied*, 393 U.S. 1015 (1969).

³⁵ 17 C.F.R. § 270.17d-1 (1974). For the content of this rule see note 36 *infra*.

³⁶ 15 U.S.C. § 80a-17(d) (1970). Section 17(d) provides, in part, that

[i]t shall be unlawful for any affiliated person of or principal underwriter for a registered investment company . . ., or any affiliated person of such a person or principal underwriter, acting as principal to effect any transaction in which such registered company, or a company controlled by such registered company, is a joint or a joint and several participant with such person, principal underwriter, or affiliated person, in contravention of such rules and regulations as the Commission may prescribe for the purpose of limiting or preventing participation by such registered or controlled company on a basis different from or less advantageous than that of such other participant.

Rule 17d-1, promulgated by the Commission under § 17(d), provides, in part, that none of the persons described in § 17(d)

acting as principal, shall participate in, or effect any transaction in connection with, any joint enterprise or other joint arrangement or profit-sharing plan in which any such registered company, or a company controlled by such registered company, is a participant

unless such person has filed an application with the Commission with respect to such transaction and such application has been granted by the Commission.

³⁷ 399 F.2d at 404. Talley Industries also contended that § 38(a) of the 1940 Act is not a general grant of power. The Second Circuit rejected this contention, stating:

Industries makes a point of the Commission's current effort to have Congress amend § 38(a) to conform its language to that, e.g., in § 20(a) of the Public Utility Holding Company Act, which empowers the SEC "to make, issue, amend and rescind such rules and regulations and such orders as it may deem necessary or appropriate to carry out the provisions of this chapter . . ." See Report of the SEC on the Policy Implications of Investment Company Growth, 89th Cong., 2d Sess., H.R. Rep. 2337, p. 343 (1966). We find it difficult to discern any truly significant difference; the Commission's purpose seems to have been to still arguments spawned by slight variations in the language of the acts it administers rather than to achieve power theretofore denied.

399 F.2d at 404 n.8.

³⁸ 399 F.2d at 405 (emphasis supplied).

unless such construction conflicts with the literal language, or clear legislative history, of a specific section of the 1940 Act.

The United States Supreme Court has utilized the same analysis to determine whether an agency's promulgation of a rule or order not specifically provided for in the relevant statute was authorized by a general grant of power, such as section 38(a) of the 1940 Act, or was implicitly authorized by the relevant statute.³⁹ Illustrative in this context is *American Trucking Associations, Inc. v. Atchison, T. & S.F. Ry.*,⁴⁰ which involved the validity of Interstate Commerce Commission rules governing trailer-on-flat-car service. A three-judge district court held the rules invalid because the Interstate Commerce Act⁴¹ did not specifically authorize such bimodal regulation.⁴² The Supreme Court, in reversing the district court, held that absent congressional prohibition the Interstate Commerce Commission should not be denied authority to regulate bimodal interconnection.⁴³ Indeed, courts have apparently favored agency innovation in adapting their procedures to deal with new situations.⁴⁴

Thus it seems that the arguments against the Commission's jurisdiction to determine an issuer's status under the 1940 Act are: (1) that section 3(b)(2) of the 1940 Act⁴⁵ impliedly limits the

³⁹ See, e.g., *FPC v. Louisiana Power & Light Co.*, 406 U.S. 621, 624 (1972); *Permian Basin Area Rate Cases*, 390 U.S. 747, 776 n.40 (1968); *American Trucking Ass'n, Inc. v. Atchison, T. & S.F. Ry.*, 387 U.S. 397 (1967); *United States v. Storer Broadcasting Co.*, 351 U.S. 192 (1956).

⁴⁰ 387 U.S. 397 (1967).

⁴¹ 49 U.S.C. §§ 2-3 (1964).

⁴² 244 F. Supp. 955 (N.D. Ill. 1965).

⁴³ 387 U.S. at 421. See also *Permian Basin Area Rate Cases*, 390 U.S. 747 (1968). While sustaining the Federal Power Commission's authority to prescribe area rates as opposed to individual rates, the Supreme Court in *Permian* stated:

This Court has repeatedly held that the width of administrative authority must be measured in part by the purposes for which it was conferred. . . . Surely the Commission's broad responsibilities therefore demand a generous construction of its statutory authority.

390 U.S. at 776 (footnote citing general grant of power contained in § 16 of Natural Gas Act, 15 U.S.C. § 717, which is similar to § 38(a) of the 1940 Act, omitted).

⁴⁴ For example, the Supreme Court observed in *American Trucking* that

[i]n fact, although we make no judgment as to the policy aspects of the Commission's action, this kind of flexibility and adaptability to changing needs and patterns of transportation is an essential part of the office of a regulatory agency. Regulatory agencies do not establish rules of conduct to last forever; they are supposed, within the limits of the law and of fair and prudent administration, to adapt their rules and practices to the Nation's needs in a volatile, changing economy. They are neither required nor supposed to regulate the present and the future within the inflexible limits of yesterday.

387 U.S. at 416.

⁴⁵ See note 13 *supra*.

Commission's jurisdiction to make status determinations to proceedings initiated thereunder by an issuer; (2) that to the extent that section 6(c) of the 1940 Act permits status determinations,⁴⁶ section 6(c) proceedings may only be initiated by the issuer; and (3) that as to Commission-initiated proceedings, the Commission's only recourse in the event that it believes a company is an unregistered investment company is to commence an action in a district court pursuant to section 42(e) of the 1940 Act.⁴⁷

Admittedly, Commission- or third-party-initiated status proceedings were apparently not contemplated by Congress at the time of the adoption of the 1940 Act. Indeed, the limited scope of section 3(b)(2) indicates that Congress did not even give much thought to voluntary issuer-initiated status proceedings. Certainly section 6(c) does not specifically authorize status proceedings. Moreover, although presumably the Commission could exempt an issuer from the 1940 Act regardless of its status, the Commission may grant such an exemption only upon a finding that "such exemption is necessary or appropriate in the public interest and consistent with the protection of investors"⁴⁸ In any event, both the statutory procedure whereby some issuers must seek determinations from the Commission (section 3(b)(2)) and the specific authorization to bring actions in the district courts (section 42(e)) ought not be construed as an indication that Congress viewed such provisions as limitations on the Commission's authority. Neither the Commission's precedents nor the relevant judicial decisions require sections 3(b)(2), 6(c), or 42(e) to be read as limitations on the Commission's plenary jurisdiction.⁴⁹

A similar issue was recently considered by the Supreme Court

⁴⁶ As mentioned in note 81 and accompanying text *infra*, the Commission has, in considering whether an exemption should be granted to an issuer in a § 6(c) proceeding, considered whether the issuer was subject to the 1940 Act. A finding in such a proceeding that an issuer is not an investment company should have the same legal effect as a § 3(b)(2) finding, *i.e.*, a conclusive finding, absent fraud, that the issuer was not an investment company on the date involved. This result should follow even though the Commission would either (1) not have had to make the public interest findings which are a prerequisite to the granting of § 6(c) exemptive relief; or (2) have denied exemptive relief if it had made such findings. Thus the Commission's jurisdiction to make such status determinations in proceedings initiated under § 6(c) would have to be based on its general powers under the 1940 Act, since § 6(c) does not specifically authorize status determinations. While § 6(c) does not define the persons who may make the application, the language of § 6(c) suggests that it may be availed of only by the person seeking exemption. In any event, who may initiate a § 6(c) proceeding is a distinct issue from the Commission's jurisdiction to make status determinations.

⁴⁷ 15 U.S.C. § 80a-41(e) (1970).

⁴⁸ *Id.* § 80a-6(c).

⁴⁹ See notes 37-38 & 60-67 and accompanying text.

in *Weinberger v. Hynson, Westcott & Dunning, Inc.*,⁵⁰ *Weinberger v. Bentex Pharmaceuticals, Inc.*,⁵¹ and two related cases,⁵² all of which involved the authority of the Food and Drug Administration ("FDA") under the Federal Food, Drugs and Cosmetic Act of 1938,⁵³ ("Food and Drug Act"), to determine whether a drug is a "new drug" for purposes of the Act.

The Food and Drug Act, as amended in 1962, defines a "new drug" as one "not generally recognized . . . as safe and effective for use under the conditions prescribed, recommended, or suggested in the labeling"⁵⁴ A "new drug" may not be marketed unless a new drug application ("NDA") filed with and approved by the FDA is effective.⁵⁵ The FDA is specifically authorized to refuse approval of an NDA or to withdraw any prior approval if substantial evidence is lacking that the drug is effective for its intended use.⁵⁶ Prior to the 1962 amendments, many drugs were marketed, for various reasons, without an effective NDA.⁵⁷ After having appropriate studies conducted, the FDA adopted procedures to determine the efficacy of various drugs, whether or not covered by an NDA, as "new drugs" under the 1962 amendments.⁵⁸ *Bentex Pharmaceuticals* and its associated cases involved various attacks on the FDA's jurisdiction to make such determinations,⁵⁹ the main contention being that the FDA's only recourse in the event that it

⁵⁰ 412 U.S. 609 (1973).

⁵¹ 412 U.S. 645 (1973).

⁵² *Ciba Corp. v. Weinberger*, 412 U.S. 640 (1973); *USV Pharmaceutical Corp. v. Weinberger*, 412 U.S. 655 (1973).

⁵³ 21 U.S.C. §§ 301-92 (1970).

⁵⁴ *Id.* § 321(p)(1). Prior to the 1962 amendments, "new drug" was defined only in terms of recognized safety, with no mention of effectiveness. *See* 21 U.S.C. § 321(p) (1958).

⁵⁵ 21 U.S.C. § 355(a) (1970). The FDA is required to approve or disapprove an NDA within 180 days after it is filed. *Id.* § 355(c).

⁵⁶ *Id.* §§ 355(d), (e).

⁵⁷ The Supreme Court described the situation as follows:

Between 1938 and 1962 FDA had permitted 9,457 NDA's to become effective. Of these, some 4,000 were still on the market. In addition, there were thousands of drugs which manufacturers had marketed without applying to FDA for clearance. These drugs, known as "me-toos," are similar to or identical with drugs with effective NDA's and are marketed in reliance on the "pioneer" drug application approved by FDA. In some cases, a manufacturer obtained an advisory opinion letter from FDA that its product was generally recognized among experts as safe.

Weinberger v. Hynson, Westcott & Dunning, Inc., 412 U.S. 609, 614 (1973).

⁵⁸ 412 U.S. at 614-15, 650-51.

⁵⁹ *Hynson, Westcott & Dunning, Ciba Corp.*, and *USV Pharmaceutical Corp.* involved proceedings brought by certain manufacturers in regard to the withdrawal of an NDA. *Bentex Pharmaceuticals* involved drugs manufactured by manufacturers who did not have an effective NDA, so-called "me-too" drugs (*see* note 57 *supra*), and was before the Supreme Court on an appeal of a court of appeals reversal of a district court's referral of the "new drug" issues to the FDA.

thought the Food and Drug Act was being violated was to commence an appropriate judicial action.⁶⁰

The Supreme Court rejected the argument that the FDA did not have jurisdiction to declare a drug a "new drug" for the purposes of the Food and Drug Act.⁶¹ In so doing, the Supreme Court stated in *Hynson, Westcott & Dunning*:

We hold that FDA by reasons [*sic*] of § 554(e) [section 5(d)] of the Administrative Procedure Act may issue a declaratory order to terminate a controversy over a "new drug" or to remove any uncertainty whether a particular drug is a "new drug" within the meaning of § 201(p)(1) of the 1938 Act

. . . .
Its determination that a product is a "new drug" or a "me-too" drug is, of course, reviewable. But its jurisdiction to determine whether it has jurisdiction is as essential to its effective operation as is a court's like power. . . .

It is argued that though FDA is empowered to decide the threshold question whether the drug is a "new drug," that power is only an incident to its power to approve or withdraw approval of NDA's. Some manufacturers, however, have no NDA's in effect and are not seeking approval of any drugs. Nevertheless, FDA may make a declaratory order that a drug is a "new drug."⁶²

Although the factual posture of *Bentex Pharmaceuticals* and its associated cases did not require the Supreme Court specifically to determine that the FDA could on its own initiative issue a declaratory order as to a drug not covered by an NDA, its opinions in these cases leave little room for doubt. The Supreme Court's view is particularly significant because such FDA-initiated determinations are not expressly authorized by the Food and Drug Act. Moreover, the Food and Drug Act, unlike the 1940 Act, does not confer a general grant of power on the FDA to promulgate orders.⁶³

⁶⁰ The main contentions, as noted by the Supreme Court in describing the holding appealed from the Court of Appeals for the Fourth Circuit (463 F.2d 363 (1972)), in *Bentex Pharmaceuticals* were that the

FDA has no jurisdiction, either primary or concurrent, to decide in an administrative proceeding what is a "new drug" for which an NDA is required. In its [the circuit court's] view the 1962 Act established two forums for the regulation of drugs: an administrative one for premarketing clearances for "new drugs" or withdrawal of previously approved NDA's, with the right of appeal; and second, a judicial one for enforcement of the requirement that "new drugs" be cleared as safe and effective before marketing by providing the Government with judicial remedies of seizure, injunction, and criminal prosecution available solely in the District Court.

412 U.S. at 648-49.

⁶¹ 412 U.S. at 624-27, 643, 653.

⁶² *Id.* at 626-27.

⁶³ 21 U.S.C. § 371(a) does confer "[t]he authority to promulgate regulations for the efficient enforcement of this chapter."

Nevertheless, the Supreme Court held that the FDA's jurisdiction was necessarily to be implied. The Court reasoned as follows: Congress has chosen the FDA to administer the Food and Drug Act;⁶⁴ the FDA "cannot administer the Act intelligently and rationally unless it has authority to determine what drugs are 'new drugs'";⁶⁵ and denial of such declaratory authority would frustrate the purposes of the Food and Drug Act as amended.⁶⁶ The Supreme Court, in rejecting the argument that FDA could only determine new drug issues in a proceeding relative to an NDA, stated that "[p]arties, of course, cannot confer jurisdiction; only Congress can do so."⁶⁷

Although the Supreme Court's focus on the generic nature of drugs⁶⁸ may be pointed to as limiting the views expressed by the Court in *Bentex Pharmaceuticals* and its associated cases, these cases clearly sustain the authority of the FDA to issue declaratory orders with respect to status issues that determine jurisdiction under the statute it administers.⁶⁹ Thus, by analogous application of the reasoning expressed in *Bentex Pharmaceuticals* and its associated cases, there should be no doubt as to the Commission's authority in connection with status determinations under the 1940 Act, no matter how initiated.

The Commission has issued declaratory rulings, including status determinations, in a variety of situations not specifically authorized by the 1940 Act, through reliance on section 5(d) of the APA and/or its general powers under the 1940 Act. For example, in *First Multifund of America, Inc.*,⁷⁰ the Commission issued a declaratory order pursuant to section 5(d) of the APA upon the joint application of a mutual fund and its investment adviser. The order determined that the adviser, in purchasing shares (of other funds) for the mutual fund, from principal underwriters of such other funds, was acting as a "broker" and, thus, under section 17 (e) of the 1940 Act,⁷¹ was entitled to accept and retain commissions

⁶⁴ 412 U.S. at 624.

⁶⁵ *Id.*

⁶⁶ *Id.* at 626.

⁶⁷ *Id.* at 652.

⁶⁸ *USV Pharmaceutical Corp. v. Weinberger*, 412 U.S. 655, 663-66 (1973).

⁶⁹ To the same effect is *Frozen Food Express v. United States*, 351 U.S. 40 (1956), in which the Supreme Court held reviewable a declaratory order of the Interstate Commerce Commission that specified that certain commodities are not "agricultural" and that, therefore, the carriage of such commodities would not be exempt under the Interstate Commerce Act. *See also Rochester Tel. Corp. v. United States*, 307 U.S. 125 (1939), which involved the authority of the Federal Communications Commission.

⁷⁰ 1940 Act Release No. 6700 (August 26, 1971).

⁷¹ 15 U.S.C. § 80a-17(e) (1970).

limited to one percent of the purchase price. The Commission also ruled on related matters concerning sections 17(a) and 22(d) of the 1940 Act.⁷² In issuing the order, the Commission considered various objections to its jurisdiction and clearly determined that, in its view, it has authority to issue declaratory orders with respect to 1940 Act matters under section 5(d) of the APA.⁷³

Moreover, in section 3(b)(2) proceedings the Commission has found an issuer exempt from section 3(a)(3) by reason of primary engagement through a wholly-owned subsidiary,⁷⁴ and in the same proceeding has concluded that it did not have to consider a section 6(c) application by a voting trust whose sole asset was stock of the exempt issuer, because the voting trust was exempt by reason of section 3(c)(14) of the 1940 Act.⁷⁵ The Commission has also made a finding in a section 3(b)(2) proceeding that an issuer is not an investment company as defined in section 3(a)(1) of the 1940 Act.⁷⁶ Indeed, although the Commission has occasionally questioned its authority to determine investment company status outside of section 3(b)(2),⁷⁷ the Commission has recognized, even over the objections of its staff,⁷⁸ the practical necessity and desirability of considering in a section 3(b)(2) proceeding an issuer's status under all relevant sections of the 1940 Act.⁷⁹

Moreover, denial of the Commission's authority to issue declaratory status orders except as specifically provided for in the 1940 Act could result in conflicts with the Commission's express powers. Clearly, either explicit or implicit in every order denying an application pursuant to section 3(b)(2) of the 1940 Act is a finding that the applicant is an investment company.⁸⁰ Many

⁷² *Id.* §§ 80a-17(a), -22(d). In addition, the Commission decided questions concerning § 26 of article III of the Rules of Fair Practice of the National Association of Securities Dealers, Inc. CCH NASD Manual ¶ 2176.

⁷³ *Cf.* Pacific Northwest Power Co., 41 S.E.C. 863 (1964), in which the commission issued a declaratory order pursuant to § 5(d) of the APA in regard to a company's status as an "electric utility company" under the Public Utility Holding Company Act of 1935. 15 U.S.C. §§ 79-79z (1970).

⁷⁴ *Broadway & 58th St. Corp.*, 12 S.E.C. 1128 (1943).

⁷⁵ *Id.* at 1134.

⁷⁶ *United States Foil Co.*, 9 S.E.C. 22 (1941).

⁷⁷ *See* note 20 *supra*.

⁷⁸ *See* *Filbert Corp.*, 15 S.E.C. 667 (1944), in which the Counsel for the Corporation Finance Division contended that a § 3(b)(2) application should be dismissed because the applicant was a § 3(a)(1) investment company. (*See* discussion of § 3(b)(2) in note 13 *supra*.) The Commission noted that the "determination of Filbert's status under §§ 3(a)(3) and 3(b)(2), however, is not a complex matter, and we think it is appropriate in this case to dispose of the question on the merits." 15 S.E.C. at 669 n.4.

⁷⁹ *See also* *General Securities Corp.*, 22 S.E.C. 97, 101 n.7 (1946); *United States Foil Co.*, 9 S.E.C. 22, 26 (1941).

⁸⁰ *See, e.g.*, *American Ry. Corp.*, 11 S.E.C. 669 (1942); *Atlantic Coast Line Co.*, 11 S.E.C.

section 3(b)(2) proceedings involve issuers that, arguably, could qualify for a section 3(b)(1) exemption, but have chosen to seek a section 3(b)(2) resolution of their status. For such an issuer, the section 3(b)(2) inquiry would involve consideration of issues that are common to those presented by section 3(b)(1), such as determinations of section 3(a)(3) valuations⁸¹ and questions of primary business engagement directly or through wholly-owned subsidiaries.⁸² A restrictive construction of the Commission's power to issue declaratory status orders might permit an unsuccessful section 3(b)(2) applicant, with an arguable section 3(b)(1) exemption, to refuse to register under the 1940 Act and to contend that the Commission's authority under section 3(b)(2) is limited, by the specific language of that section, to declaring that an issuer is *not* an investment company.⁸³ If such a contention were sustained, the Commission might be required to relitigate the section 3(a)(3) and 3(b)(1) issues in a district court.⁸⁴ Needless to say, such a position would emasculate the Commission's functions under the

661 (1942). Illustrative is Prudential Ins. Co., 41 S.E.C. 335 (1963). Prudential, a variable annuity account sponsor, applied for an order "declaring that the offer and sale of variable annuity contracts will not subject Prudential, in whole or in part, to the Act" (*id.* at 336), or in the alternative for exemptive relief from certain provisions of the 1940 Act. The application was made pursuant to §§ 3(b)(2), 3(c)(3), and 38(a) of the 1940 Act. The Commission denied the application on the merits with respect to §§ 3(b)(2) and 3(c)(3), but granted § 6(c) exemptive relief from certain provisions of the 1940 Act. Implicit in the denial of the §§ 3(b)(2) and 3(c)(3) requests, and the granting of § 6(c) relief, was the conclusion by the Commission that it could determine whether an issuer is an investment company, a procedure not specifically authorized by the 1940 Act.

⁸¹ See, e.g., Tobacco Prods. Export Corp., 12 S.E.C. 743 (1943). If the issuer seeks the certainty of a § 3(b)(2) order, its application would most likely concede that it is, or will be, a § 3(a)(3) investment company, since, otherwise, the Commission might decline to entertain the application under § 3(b)(2). See note 13 *supra*. Such a position might preclude the issuer's opportunity to subsequently claim that it was not a § 3(a)(3) investment company. Cf. note 109 *infra*.

⁸² See, e.g., Case, Pomeroy & Co., 17 S.E.C. 844 (1944).

⁸³ The Commission has also exercised its jurisdiction over persons not registered under the Act to grant "declaratory" orders in the form of prospective complete exemptions from the 1940 Act pursuant to § 6(c) thereof. In Business Development Corp. of Nebraska, 1940 Act Release No. 5967 (Jan. 30, 1970), the Commission granted an exemption from all of the provisions of the 1940 Act pursuant to § 6(c). The applicant had been formed for the purpose of promoting the economic development of the state of Nebraska and proposed to make a public offering of shares of its common stock. Since the applicant proposed to acquire investment securities having a value exceeding 40 percent of its total assets, it would have been required to register under the 1940 Act, unless granted exemption pursuant to § 6(c). Explicit in this prospective exemption proceeding was a finding that the applicant would have been an investment company. See also Bankers Trust N.Y. Corp., 1940 Act Release No. 5981 (Feb. 19, 1970); Bank Fiduciary (Equity) Fund, 1940 Act Release No. 5993 (Feb. 27, 1970).

⁸⁴ A district court may hold that the unsuccessful applicant is precluded from relitigating the §§ 3(a)(3) and 3(b)(1) issues. See note 109 *infra*.

1940 Act.⁸⁵ The Commission has also issued declaratory orders without relying on section 5(d) of the APA with respect to, for example, sections 18(j)⁸⁶ and 17(d)⁸⁷ of the 1940 Act.

Although the Commission appears, in effect, to have ample authority under the 1940 Act to make status determinations by declaratory order without relying on section 5(d) of the APA, the Supreme Court's reliance on section 5(d) in *Bentex Pharmaceuticals* and *Hynson, Westcott & Dunning* warrants further examination of section 5(d) as applied to the 1940 Act.

Indeed, until *First Multifund*,⁸⁸ discussed above, the Commission had expressed reservations as to the availability of section 5(d) for 1940 Act orders.⁸⁹ Section 5(d) is by its terms available in every "case of adjudication required by statute to be determined on the record after opportunity for an agency hearing. . . ."⁹⁰ This requirement appears to be satisfied by sections 40(a) and 43(a) of the 1940 Act. Section 40(a) provides that "[o]rders of the Commission under this subchapter shall be issued only after appropriate notice and opportunity for hearing."⁹¹ Section 43(a)⁹² of the 1940 Act, which provides for judicial review of Commission orders, makes several references to a record, clearly contemplating, and implicitly requiring, the existence of a "record" and determination thereon.⁹³

⁸⁵ See text accompanying notes 118-19 *infra*.

⁸⁶ State Bond & Mortgage Co., 1940 Act Release No. 4685 (Aug. 25, 1966). *State Bond & Mortgage Co.* involved an application for an order of the Commission that certain stock options granted by the applicant were not securities for purposes of § 18(j) of the 1940 Act, or in the alternative for an exemption from § 18(j) pursuant to § 6(c). The Commission concluded that the stock options were securities. *Id.* at 4.

⁸⁷ Talley Industries, Inc., 1940 Act Release No. 5358 (April 19, 1968). Applicants sought a determination that § 17(d) and Rule 17d-1 were inapplicable to the purchase by an investment company and an affiliated person of securities of a third party or, in the alternative, a retroactive exemption. The Commission held that the statute and rule were applicable and denied the exemption sought.

⁸⁸ 1940 Act Release No. 6700 (Aug. 26, 1971).

⁸⁹ See *Fundamental Investors, Inc.*, 41 S.E.C. 285 (1962), in which it was noted that

[e]ven Section 5(d) of the Administrative Procedure Act . . . would not empower the Commission to issue a declaratory order in the absence of specific provisions in Section 2(a)(9) for determinations by the Commission upon questions of control.

Id. at 297 n.28.

⁹⁰ 5 U.S.C. § 554(a) (1970).

⁹¹ 15 U.S.C. § 80a-39(a) (1970).

⁹² *Id.* § 80a-42(a).

⁹³ This position is also supported by the *Attorney General's Manual on the Administrative Procedure Act* (1947), which states that, as regards the Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-78hh (1970), the "on-the-record" requirement "is clearly implied in the provision for judicial review of these orders in the circuit court of appeals." ATTORNEY

However, two recent Supreme Court cases involving section 4 of the APA,⁹⁴ *United States v. Allegheny-Ludlum Steel Corp.*⁹⁵ and *United States v. Florida East Coast Ry.*⁹⁶ raise some questions. In *United States v. Florida East Coast Ry.*, the Supreme Court held that rules issued by the Interstate Commerce Commission under section 1(14)(a) of the Interstate Commerce Act,⁹⁷ which required that such rules be issued "after hearing," did not satisfy the "on the record" requirement of section 4 of the APA (which brings into operation the provisions of sections 7 and 8 of the APA).⁹⁸ The Supreme Court stated:

We recognized in *Allegheny-Ludlum* that the actual words "on the record" and "after . . . hearing" used in § 553 [APA section 4] were not words of art, and that other statutory language having the same meaning could trigger the provisions of §§ 556 and 557 [APA sections 7 and 8] in rulemaking proceedings. But we adhere to our conclusion, expressed in that case, that the phrase "after hearing" in § 1(14)(a) of the Interstate Commerce Act does not have such an effect.⁹⁹

Although *Florida East Coast Ry.* and *Allegheny-Ludlum* suggest that more than an implied on-the-record requirement may be needed to trigger section 5(d) of the APA, in its decisions dealing with section 5(d) of the APA, the Supreme Court has not discussed the "on-the-record" requirement¹⁰⁰ and has sustained section 5(d) declaratory orders in cases where the statute involved did not even imply an "on-the-record" requirement.¹⁰¹

GENERAL'S MANUAL, *supra*, at 41. Section 25(a) of the Securities Exchange Act of 1934, 15 U.S.C. § 78y (1970), which provides for such review, is virtually identical to § 43(a) of the 1940 Act.

⁹⁴ Section 4 of the APA provides for public notice of proposed agency rulemaking and requires the agency to permit interested persons to participate in the rulemaking procedure by allowing the submission of comments. Section 4(c) provides, however, that "[w]hen rules are required by statute to be made on the record after opportunity for an agency hearing, sections 556 and 557 [§§ 7 and 8 of the APA] of this title shall apply instead of this subsection." 5 U.S.C. § 553(c) (1970). See note 98 *infra*.

⁹⁵ 406 U.S. 742 (1972).

⁹⁶ 410 U.S. 224 (1973).

⁹⁷ 49 U.S.C. § 1(14)(a) (1970).

⁹⁸ 5 U.S.C. §§ 553(c), 556-57 (1970). Sections 7 and 8 of the APA provide for certain procedural requirements relative to rulemaking and concerning such matters as the conduct of hearings, burden of proof, evidence, initial decision and agency review.

⁹⁹ 410 U.S. at 238 (emphasis added).

¹⁰⁰ See *Red Lion Broadcasting Co. v. FCC*, 395 U.S. 367 (1969); *Pennsylvania R.R. v. United States*, 363 U.S. 202 (1960); *Service Storage & Transfer Co. v. Virginia*, 359 U.S. 171 (1959); *Boston & Me. R.R. v. United States*, 358 U.S. 68 (1958); *Wong Yang Sung v. McGrath*, 339 U.S. 33 (1950).

¹⁰¹ See *Weinberger v. Hynson, Westcott & Dunning, Inc.*, 412 U.S. 609 (1973); *Red*

In *Hynson, Westcott & Dunning*, one of the companion cases to *Bentex Pharmaceuticals*, the Supreme Court upheld the authority of the FDA to "make a declaratory order that a drug is a 'new drug,'" ¹⁰² despite the fact that the Food and Drug Act does not provide for such orders, and, therefore, does not provide for an "on-the-record" determination. Nevertheless, the Supreme Court noted, apparently referring to the declaratory order procedure, that the "procedure is a permissible one where every manufacturer of a challenged drug has an opportunity to be heard."¹⁰³ This is consistent with the Supreme Court's decision in *Wong Yang Sung v. McGrath*,¹⁰⁴ in which the Court held that the section 5 "hearing-required-by-statute" provision was satisfied by reading a hearing requirement into a statute so as to satisfy the constitutional requirement of due process. In none of these cases did the Supreme Court discuss an "on-the-record" requirement. This lack of discussion evidently stems from an expectation that orders emanating from a hearing in an adjudicatory proceeding would be based on the record of that hearing.¹⁰⁵ Thus, the Supreme Court appears to apply the "on-the-record" requirement of section 5 (which is applicable to adjudicatory proceedings) different from the "on-the-record" requirements of section 4 (which is applicable to rulemaking proceedings),¹⁰⁶ and under the Court's section 5 decisions, the "on-the-record" requirement is met with respect to orders under the 1940 Act.

Finally, it should be noted that section 5(d) is not available for

Lion Broadcasting Co. v. FCC, 395 U.S. 367 (1969); *Wong Yang Sung v. McGrath*, 339 U.S. 33 (1950). In this regard, with reference to the Supreme Court cases involving ICC orders, Professor Davis has noted:

The ICC is tacitly assuming power to issue declaratory orders under § 5(d), irrespective of the limitations stated in the introductory clause of § 5, and the Supreme Court is tacitly approving. Neither the Court nor the Commission has shown any concern for the limitations in the introductory clause. The result, from a practical standpoint, is sound, because the declaratory-order power is needed and useful, and the limitations in the introductory clause were not drafted with declaratory orders in mind.

K. DAVIS, ADMINISTRATIVE LAW TREATISE (Supplement) § 4.10, at 201 (1970).

¹⁰² 412 U.S. at 627.

¹⁰³ 412 U.S. at 625.

¹⁰⁴ 339 U.S. 33 (1950).

¹⁰⁵ *Cf.*, e.g., *Philadelphia Co. v. SEC*, 175 F.2d 808, 817 (D.C. Cir. 1948), *vacated as moot*, 337 U.S. 901 (1949).

¹⁰⁶ The distinction was also noted by the Supreme Court in *Florida East Coast Ry.*:

The term "hearing" in its legal context undoubtedly has a host of meanings. Its meaning undoubtedly will vary, depending on whether it is used in the context of a rulemaking-type proceeding or in the context of a proceeding devoted to the adjudication of particular disputed facts.

410 U.S. at 239 (footnote omitted).

adjudications that are "subject to a subsequent trial of the law and the facts de novo in a court."¹⁰⁷ As discussed above, status orders of the Commission are authorized by the 1940 Act; consequently, such orders would be reviewable under section 43(a) of the 1940 Act, which provides that "[t]he findings of the Commission as to the facts, if supported by substantial evidence, shall be conclusive."¹⁰⁸ Moreover, even if section 43(a) were held inapplicable to declaratory orders or if the issue were raised in a subsequent collateral litigation between the Commission and the party affected by the order (*i.e.*, not involving a direct review of such order), the standard of section 43(a) should be applicable.¹⁰⁹ The proposition that 1940 Act declaratory orders are subject to review de novo has also been rejected by the Commission.¹¹⁰

The Supreme Court's treatment of declaratory orders, particularly in *Hynson, Westcott & Dunning*, clearly parts with traditional views as to the limitations of section 5 of the APA.¹¹¹ In

¹⁰⁷ 5 U.S.C. § 554(a)(1) (1970).

¹⁰⁸ 15 U.S.C. § 80a-42(a) (1970).

¹⁰⁹ The Court of Appeals for the Second Circuit stated in *SEC v. Talley Indus., Inc.*, 399 F.2d 396 (2d Cir. 1968), *cert. denied*, 393 U.S. 1015 (1969):

To be sure the case is not here on a petition to review the SEC's order denying Industries' application for retrospective approval, and the provision of § 43(a) making its findings conclusive if supported by substantial evidence thus is not applicable by its terms. But the principle underlying that rule—that a factual determination by an agency responsible for the execution of Congressional policy and vested with expertise shall not be disturbed by a court where there is substantial evidence to support it—applies none the less, and it would be little short of absurd for us to decline to follow the same standard by which a court reviewing the Commission's order would be bound. *Cf. SEC v. Central Illinois Securities Corp.*, 338 U.S. 96, 113-27, 69 S. Ct. 1377, 93 L. Ed. 1836 (1949).

399 F.2d at 403. *Cf. Ciba Corp. v. Weinberger*, 412 U.S. 640 (1973), in which the Supreme Court noted:

Where there is, however, an administrative determination [as to "new-drug" issues], whether it be explicit or implicit in the withdrawal of an NDA, the tactic of "reserving" the threshold question (the jurisdictional issue) for later judicial determination is not tolerable. There is judicial review of FDA's ruling. But petitioner, having an opportunity to litigate the "new drug" issue before FDA and to raise the issue on appeal to a court of appeals, may not relitigate the issue in another proceeding.

Id. at 644 (citation omitted).

¹¹⁰ First Multifund of America, Inc., 1940 Act Release No. 6700 (Aug. 26, 1971). The Commission stated that its order would be "completely effective without the necessity for judicial retrial or decision." *Id.* at 10. In *Hynson, Westcott & Dunning*, the Supreme Court noted that § 5(d) was available in a situation where review would be in a district court under § 10(c) of the APA (5 U.S.C. § 703 (1970)) (the Food and Drug Act not providing for such review). 412 U.S. at 626-27. In reaching this conclusion, the Court by implication must have found that agency orders do not require a statutory aid, such as § 43(a), to make the findings of fact on which they are based conclusive, if supported by substantial evidence. *Cf. Ciba Corp. v. Weinberger*, 412 U.S. 640, 644 (1973).

¹¹¹ *Cf.* 1 K. DAVIS, ADMINISTRATIVE LAW TREATISE § 4.10 (1958).

those cases the FDA determined on its own initiative that there was an uncertainty as to the status of various drugs under the Food and Drug Act and adopted procedures to resolve that uncertainty. The Supreme Court's affirmance of that procedure was based more on practical considerations than on an analytical examination of the relevant statutes.¹¹²

Having found implied jurisdiction in the FDA to consider "new drug" and related issues, the Supreme Court could then find, as it did in *Bentex Pharmaceuticals*, that a district court's referral of such issues to the FDA "was appropriate, as these are the kinds of issues peculiarly suited to initial determination by the FDA."¹¹³ Quoting its opinion in *Far Eastern Conference v. United States*,¹¹⁴ the Supreme Court noted:

In cases raising issues of fact not within the conventional experience of judges or cases requiring the exercise of administrative discretion, agencies created by Congress for regulating the subject matter should not be passed over.¹¹⁵

Although the primary jurisdiction aspects of *Hynson, Westcott & Dunning* and *Bentex Pharmaceuticals* are not relevant to the existence of jurisdiction to grant declaratory orders, they do bear on the Commission's responsibility to make declaratory status determinations. The primary jurisdiction doctrine as applied by the Supreme Court in *Bentex Pharmaceuticals* and other recent cases¹¹⁶ is clearly more than a matter of statutory construction or jurisdiction; rather, it is a pragmatic restraint aimed at achieving an efficient and rational division of agency and judicial responsibility.¹¹⁷ As the Supreme Court has noted:

Uniformity and consistency in the regulation of business entrusted to a particular agency are secured, and the limited functions of review by the judiciary are more rationally exercised, by preliminary resort for ascertaining and interpreting the

¹¹² See text accompanying notes 64-66 *supra*.

¹¹³ 412 U.S. at 653.

¹¹⁴ 342 U.S. 570 (1952).

¹¹⁵ 412 U.S. at 654.

¹¹⁶ See, e.g., *Ricci v. Chicago Mercantile Exchange*, 409 U.S. 289 (1973); *Port of Boston Marine Terminal Ass'n v. Rederiaktiebolaget Transatlantic*, 400 U.S. 62 (1970); *Rosado v. Wyman*, 397 U.S. 397 (1970).

¹¹⁷ Primary jurisdiction is generally said to arise only where the courts and the agency possess concurrent jurisdiction. 3 K. DAVIS, *supra* note 111, § 19.01-.09. *But see Ricci v. Chicago Mercantile Exchange*, 409 U.S. 289 (1973), in which the Supreme Court held that the Court of Appeals had properly stayed an antitrust proceeding while awaiting a decision on certain issues in the case by the Commodities Exchange Commission, even though the CEC had no authority to decide the antitrust issue involved.

circumstances underlying legal issues to agencies that are better equipped than courts by specialization, by insight gained through experience, and by more flexible procedure.¹¹⁸

Such considerations are especially pertinent to the determination of investment company status. The courts may have the last word on matters arising under the 1940 Act, but in view of the complexity of the regulatory scheme imposed by the 1940 Act and the Commission's experience, broad powers, and responsibilities thereunder, the Commission should have the first.¹¹⁹ Such a result is particularly appropriate since the Commission may decide to exercise its authority under section 6(c) of the 1940 Act to retroactively or prospectively exempt an issuer which is found to have been an unregistered investment company.¹²⁰ Indeed, in *Natco Corp. v. Great Lakes Industries, Inc.*,¹²¹ the only case to find that a target company has standing to question the offeror's status under the 1940 Act, the district court referred the issue of the defendant's status under the 1940 Act to the Commission.¹²²

The decision of a district court to refer a matter to an administrative agency is apparently a matter of discretion,¹²³ but reviewable discretion.¹²⁴ Section 5(d) of the APA provides that agencies in their "sound discretion" may issue declaratory orders; nevertheless, such discretion is reviewable.¹²⁵ If, therefore, it may be an abuse of discretion for a district court not to refer an issue of investment

¹¹⁸ *Far Eastern Conference v. United States*, 342 U.S. 570, 574-75 (1952) (quoted in *Bentex Pharmaceuticals*, 412 U.S. at 654).

¹¹⁹ *But see* *Fundamental Investors, Inc.*, 41 S.E.C. 285 (1962).

¹²⁰ *Cf. Ricci v. Chicago Mercantile Exchange*, 409 U.S. 289 (1973).

¹²¹ 214 F. Supp. 185 (W.D. Pa. 1962), *appeal dismissed*, [1961-64 Transfer Binder] CCH FED. SEC. L. REP. ¶ 91,236 (3d Cir. 1963).

¹²² More recent cases have held that the 1940 Act was intended to protect shareholders of investment companies, and not to protect target companies, and that, therefore, a target company does not have standing to assert the 1940 Act violations of the offeror. *See, e.g., Herpick v. Wallace*, 430 F.2d 792 (5th Cir. 1970); *D-Z Investment Co. v. Halloway*, CCH FED. SEC. L. REP. ¶ 94,771 (S.D.N.Y. 1974).

¹²³ In *USV Pharmaceutical Corp. v. Weinberger*, 412 U.S. 655 (1973), one of the companion cases to *Bentex Pharmaceuticals*, the Supreme Court specifically noted that its affirmance of a Circuit Court decision on the merits of a "new-drug" issue was "not meant to indicate that the District Court, had it concluded that its jurisdiction was concurrent with that of FDA, would not have abused its discretion in refusing to stay this action pending the outcome of administrative proceedings." 412 U.S. at 659 n.1.

¹²⁴ Most primary jurisdiction cases have involved the propriety of a district court's referral. However, appellate courts have on occasion instructed a district court to refer a matter to the relevant agency. *See, e.g., Watts v. Missouri-Kan.-Tex. R.R.*, 383 F.2d 571, 586 (5th Cir. 1967).

¹²⁵ S. Doc. No. 248, 79th Cong., 2d Sess. 25 (1946); 1 K. DAVIS, *supra* note 111, § 4.10 at 276-78.

company status to the Commission, would it not be undesirable for the Commission to decline to entertain an issuer's application or a third party's application which raises substantial questions as to an issuer's status under the 1940 Act, or, indeed, to ignore materials in its files which raise such questions?¹²⁶

The considerations applicable to a Commission determination to commence a declaratory proceeding would be different than those applicable to its determination to entertain an issuer's, or a third party's, application. For example, if the Commission concludes in a particular situation that declaratory resolution of an issue would be ineffective to redress damages caused by wilful or serious violation of the substantive provisions of the 1940 Act, it might commence an enforcement action seeking remedial relief. Apart from such cases, the Commission might be best advised to settle questions of investment company status by a declaratory proceeding.¹²⁷

A clear example of the unsatisfactory situations that may result from such enforcement proceedings is the Commission's nonacquiescence in the district court's findings in *SEC v. Fifth Avenue Coach Lines, Inc.*,¹²⁸ in which the district court held that, for purposes of section 3(a)(3) of the 1940 Act, certificates of deposit maturing in ninety days or less and a six-month time deposit were "cash items" and not "investment securities."¹²⁹ The Commission had contested this and still has not acquiesced in the court's holding.¹³⁰ Thus, issuers have before them a district court

¹²⁶ Cf. *Retail Store Employees, Local 880 v. FCC*, 436 F.2d 248 (D.C. Cir. 1970); *Fundamental Investors, Inc.*, 41 S.E.C. 285 (1962).

¹²⁷ Such proceedings may prove to be a more efficient use of the Commission's resources and are more likely to result in authority that reflects a consistent, coherent legal framework that may be relied upon by issuers and their counsel.

¹²⁸ 289 F. Supp. 3 (S.D.N.Y. 1968), *aff'd*, 435 F.2d 510 (2d Cir. 1970).

¹²⁹ 289 F. Supp. at 31-33. The Commission had argued to the contrary. The issue could be significant for issuers that temporarily have obtained substantial cash, such as the proceeds of a public offering, and would like to receive a return on those funds pending their ultimate use in noninvestment activities. The dilemma for such an issuer is that, if it relies on the district court's holding, the Commission or a dissident shareholder may at some date claim that the issuer had been an unregistered investment company. As noted in note 8, *supra*, the penalties for operating as an unregistered investment company may be severe. Of course, the alternative would be to adhere to the Commission's position and forego the possible higher returns generally available from certificates of deposit, by investing the funds in United States debt obligations, which are specifically excluded by § 3(a)(3) from the definition of investment securities.

¹³⁰ In answering a request concerning the Commission's position on the district court's holding in *Fifth Ave. Coach*, the Chief Counsel of the Commission's Division of Investment Management Regulation stated:

[T]he Commission has not acquiesced in the *Fifth Avenue* holding as it applied to

precedent, which, however, in the Commission's view, may not be relied upon.

Issuer applications for investment company status determinations should present the least problems. As shown above,¹³¹ despite the Commission's jurisdictional concerns, it has often granted such determinations in section 3(b)(2) and section 6(c) proceedings. Nevertheless, until clarified by the Commission there will continue to be uncertainty as to the availability and scope of the declaratory order procedure.

The most innovative use of declaratory status proceedings involves third-party-initiated proceedings, particularly proceedings brought by persons who might not have standing in the federal courts. For example, virtually all target company suits alleging that the offeror is an unregistered investment company have been dismissed for lack of standing.¹³² However, since the judicial concept of standing would not appear applicable to agency proceedings,¹³³ the Commission could entertain third-party

the facts of that case. In this connection please note that the Court of Appeals indicated that the evidence might have supported a holding that Fifth Avenue became an investment company at a date earlier than the date determined by the trial court. However, the Court of Appeals did not decide the issue since the Commission did not cross-appeal the District Court's holding. . . . In my view, the failure of the Commission to cross-appeal on this issue did not constitute an acquiescence; the Commission had won all major issues in the case and the other parties were appealing.

Whether or not the Commission would take action for violation of the Investment Company Act if a company had 40% or more of its assets in certificates of deposits or time deposits would depend on the facts of the case.

Interpretative Letter, Samuel Lippman (Div. of Investment Management Regulation, October 19, 1973).

¹³¹ See text accompanying notes 74-79 *supra*.

¹³² See notes 121-22 and accompanying text *supra*.

¹³³ The standing concept evolved out of the jurisdictional requirement of a "case or controversy." As the Supreme Court has stated, "the question of standing in the federal courts is to be considered in the framework of Article III which restricts judicial power to 'cases' and 'controversies.'" *Association of Data Processing Service Orgs., Inc. v. Camp*, 397 U.S. 150, 151 (1970). There is a basic distinction between the role of a court and that of a federal agency, however. Whereas a court usually limits its inquiries to facts presented by the parties, and the relief requested by them, an agency need not so limit itself. As the Court of Appeals for the District of Columbia noted in *Retail Store Employees Local 880 v. FCC*, 436 F.2d 248 (D.C. Cir. 1970):

We have previously had occasion to point out that the Federal Communications Commission was intended by Congress to function as far more than a mere referee between conflicting parties. Regardless of the formal status of a party, or the technical merits of a particular petition, the FCC "should not close its eyes to the public interest factors" raised by material in its files. We have noted that, as a general matter, the federal regulatory agencies should construe pleadings filed before them so as to raise rather than avoid important questions. They "should not adopt procedures that foreclose full inquiry into broad public interest questions, either patent or latent."

436 F.2d at 254 (footnotes omitted).

proceedings without concern for the applicant's standing. The objection would be made, of course, that the target company's application was merely a dilatory tactic to frustrate the takeover. The Commission is capable, however, of quickly evaluating the substantiality of the issues presented by the application. If the application were frivolous, it could be dismissed summarily.¹³⁴ Moreover, as the Commission has noted, it may use its exemptive power to prevent any hardship that would be imposed by a finding that an issuer is an investment company.¹³⁵ The Commission would also have the opportunity to prevent unlawful transactions before they occur, rather than leaving the situation to be remedied at some future date. Regardless of the efficacy of remedial relief in discouraging others from violating the 1940 Act, it is not likely to restore injured parties to the *status quo ante*.

A brief analysis of the powers of the Commission to deal with issuers who refuse to participate in a declaratory status proceeding initiated by the Commission or a third party and/or refuse to obey a Commission order in such a proceeding is warranted. The Commission has ample authority under various provisions of the 1940 Act and section 5(d) of the APA, and sufficient procedural regulations in its Rules of Practice,¹³⁶ to permit it to initiate and conduct declaratory status proceedings. Section 40(a) of the 1940 Act¹³⁷ and Rule VI of the Commission's Rules of Practice¹³⁸ require personal service upon each party to the proceeding. Section 42(b)¹³⁹ empowers the Commission to subpoena witnesses and requires the production of documents for the purpose of any proceeding under the 1940 Act. Although the Supreme Court has noted that a party's willingness to participate is not determinative of jurisdiction,¹⁴⁰ section 42(c) of the 1940 Act¹⁴¹ specifically authorizes the Commission to invoke the aid of the federal courts in the case of contumacy, and further provides that willful failure to obey a subpoena of the Commission is punishable by fine and/or imprisonment. Similarly, once the Commission issues a declaratory order finding an issuer to be an investment company, the failure of

¹³⁴ See *Fundamental Investors, Inc.*, 41 S.E.C. 285, 294 (1962).

¹³⁵ *Id.* at 294-95.

¹³⁶ SEC Reg. 201.11, 17 C.F.R. § 201.11 (1974).

¹³⁷ 15 U.S.C. § 80a-39(a) (1970).

¹³⁸ SEC Reg. 201.6(b), 17 C.F.R. § 201.6(a)-(b) (1974).

¹³⁹ 15 U.S.C. § 80a-41(b) (1970).

¹⁴⁰ *Weinberger v. Bentex Pharmaceuticals, Inc.*, 412 U.S. 645 (1973); see text accompanying note 67 *supra*.

¹⁴¹ 15 U.S.C. § 80a-41(c) (1970).

the issuer to register as such could warrant the use of the criminal sanction of section 49¹⁴² of the 1940 Act intended to penalize a willful violation of an order of the Commission.

CONCLUSION

The Commission has ample jurisdiction under the 1940 Act and section 5(d) of the APA to make investment company status determinations in proceedings initiated by issuers, third parties, or the Commission itself.

The Commission's sweeping responsibilities under the 1940 Act strongly suggest that the Commission should be the forum in which questions of investment company status are first considered; in many instances, the Commission may be the only forum in which such issue may be raised. The public interest is not served by the Commission's reluctance to exercise its authority to entertain status proceedings. The Commission ought to reconsider its jurisdiction to make status determinations under the 1940 Act and reconsider the suitability of its Rules of Practice as applied to such proceedings and should, to the extent necessary, clarify or modify its Rules so as to accommodate such proceedings.

¹⁴² *Id.* § 80a-48.