Ref. No. 97-16-CC
Puerto Rico Balanced Fund, Inc.
File No. 132-3

RESPONSE OF THE OFFICE OF CHIEF COUNSEL
DIVISION OF INVESTMENT MANAGEMENT

By letter dated January 10, 1997, you seek assurance that the staff will not recommend enforcement action to the Commission if the Puerto Rico Balanced Fund, Inc. (the "Fund") does not register under the Investment Company Act of 1940 (the "Investment Company Act") in reliance on Section 6(a)(1) of the Investment Company Act.

Facts

You represent that the Fund will be organized as a Puerto Rico corporation and will register with the Office of the Commissioner of Financial Institutions of Puerto Rico as a non-diversified closed-end or open-end management investment company under the Investment Companies Act of Puerto Rico. You represent that the Fund's principal office will be located in Puerto Rico, and the Fund's official books and records will be maintained in Puerto Rico. You also represent that a majority of the Fund's officers and directors will be Puerto Rico residents, and the Fund's board meetings and any shareholder meetings will take place in Puerto Rico.

You state that the Fund's investment objective will be to seek both capital appreciation and current income exempt (in whole or in part) from federal and Puerto Rico income taxes. You state that the Fund will invest its assets in both equity and debt securities. You further state that the Fund intends to enter into transactions such as repurchase agreements, reverse repurchase agreements, and swaps for non-speculative purposes ("hedging transactions"). You state that while the Fund intends to invest in securities of Puerto Rico issuers, and engage in hedging transactions with Puerto Rico counterparties, the Fund also intends to invest in securities of issuers, and engage in hedging transactions with counterparties, organized and domiciled outside of Puerto Rico. You maintain that non-Puerto Rico counterparties often offer the most favorable terms on certain types of transactions.

You represent that the Fund intends to conduct its portfolio securities and other transactions with Puerto Rico broker-dealers whenever possible, subject to best price and best execution. You also state, however, that the Fund intends to use non-Puerto Rico broker-dealers, because many of the Fund's securities, including securities of some Puerto Rico issuers, will be traded outside of Puerto Rico.

You represent that the Fund's portfolio investments will be managed by PaineWebber Incorporated of Puerto Rico ("PW Puerto Rico"), alone or jointly with another Puerto Rico financial

institution (together, the "Advisers").[1] You state that in order to obtain investment expertise with respect to equity and corporate debt securities of non-Puerto Rico issuers, the Advisers expect to enter into separate sub-investment advisory agreements with one or more United States sub-advisers (the "Sub-Advisers"). With respect to certain matters, such as the selection of specific equity securities (and possibly corporate debt securities), you state that the Sub-Advisers will have full investment discretion, although they will be accountable to the Advisers and, ultimately, the Fund, for these decisions. You state that the Advisers will have sole authority for making investment decisions for the Fund as to all other securities and related transactions, such as income securities other than corporate debt.[2]

You state that a Puerto Rico financial institution (the "Administrator") will act as administrator for the Fund. You state that this entity will have full responsibility to assure that the Fund is provided such services as: (i) preparing the Fund's financial statements and coordinating with the Fund's outside auditors in connection with their annual audit; (ii) monitoring and assisting in the Fund's compliance with all applicable laws and regulations; and (iii) calculating the Fund's expense accruals. You also represent that the Administrator, with the assistance of the Advisers and Sub-Advisers, will have the responsibility for valuing the Fund's portfolio investments. The Administrator will also be responsible for (i) calculating the net asset value of the Fund's common stock (the "Common Stock"), and (ii) paying other service providers, all of which will be done from Puerto Rico.

You represent that a custodian bank (the "Custodian") located in Puerto Rico will hold the Fund's investments, other than those held in book-entry form. You also represent that the same or another Puerto Rico financial institution (the "Transfer Agent") will act as transfer agent for the Fund.

You state that the Fund proposes to issue debt securities, such as commercial paper and medium-term notes (the "Debt Securities") and Common Stock (the Common Stock and the Debt Securities referred to together as the "Securities"). You represent that the Fund will offer and sell the Securities only

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[1] You state that PW Puerto Rico is a broker-dealer registered under the Securities Exchange Act of 1934 that has its sole place of business, and is incorporated, in Puerto Rico. PW Puerto Rico is a wholly owned subsidiary of PaineWebber Incorporated, a Delaware corporation.

[2] Telephone conversation among Edward Rubenstein, Brian Kaplowitz, and Susan Mattisinko (Apr. 8, 1997).

to individuals having their principal residence in Puerto Rico, and entities having their principal office and place of business in Puerto Rico ("Puerto Rico residents").[3] In addition, you represent that the Fund's prospectus, and each certificate for the Securities, will state that the Securities may be sold, pledged, hypothecated, or otherwise transferred only to Puerto Rico residents. You further represent that the Fund's prospectus will inform investors that if they cease to be Puerto Rico residents, they must liquidate their investment in the Fund as soon as it is economically feasible to do so.

You represent that the initial offering of the Common Stock will be conducted by one or more underwriters, each of which will be a Puerto Rico resident. You represent that the underwriters will include PW Puerto Rico and BP Capital Markets, Inc., a subsidiary of Banco Popular de Puerto Rico, which is a financial institution chartered and having its principal office and place of business in Puerto Rico. Broker-dealers that are residents in Puerto Rico, including PW Puerto Rico and BP Capital Markets, Inc., will also be responsible for sales of the Debt Securities. You also represent that the secondary market for the Securities will be made solely by broker-dealers that are Puerto Rico residents. Thus, you maintain that neither the issuance of, nor trading in, the Securities will have a nexus to the United States or anywhere else outside of Puerto Rico.

Analysis

Section 6(a)(1) exempts from regulation under the Investment Company Act:

> Any company organized or otherwise created under the laws of and having its principal office and place of business in Puerto Rico, the Virgin Islands, or any other possession of the United States; but such exemption shall terminate if any

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[3] You maintain that because of certain tax advantages, which are available only to Puerto Rico residents, and the mix and types of portfolio securities that the Fund will own, the Fund would not, as an economic matter, be a suitable investment vehicle for anyone other than Puerto Rico residents. You state that dividends or interest generated from an investment in the Fund will be exempt from Puerto Rico and United States income tax only in the hands of individuals residing in Puerto Rico and entities organized in Puerto Rico, or elsewhere outside of the United States with their principal place of business in Puerto Rico. Moreover, you state that in order for the Fund to comply with the intra-state offering exemption from registration under Section 3(a)(11) of the Securities Act of 1933, and Rule 147 thereunder, the Fund may offer its Securities only to Puerto Rico residents.

security of which such company is the issuer is offered for sale or sold after the effective date of this title, by such company or an underwriter therefor, to a resident of any State other than the State in which such company is organized.

You maintain that the Fund should be viewed as meeting the requirements of Section 6(a)(1) of the Investment Company Act, notwithstanding that the Fund proposes to (i) retain one or more United States entities as Sub-Advisers; (ii) invest in securities of non-Puerto Rico issuers and enter into hedging transactions with non-Puerto Rico counterparties; and (iii) conduct portfolio securities transactions with non-Puerto Rico broker-dealers. We agree. In determining whether a fund has its "principal office and place of business in Puerto Rico," for purposes of Section 6(a)(1), the staff considers the totality of a fund's contacts with Puerto Rico, and does not consider any one factor to be controlling. As a general matter, we believe that the jurisdiction in which a fund invests its assets should not be a factor in determining the location of its principal place of business for purposes of Section 6(a)(1).[4]

Based on the facts and representations in your letter, we would not recommend enforcement action to the Commission if the Fund relies on Section 6(a)(1) of the Investment Company Act and does not register as an investment company under the Investment Company Act. Because this response is based on the facts and representations in your letter, you should note that different facts or representations may require a different conclusion.

Edward J. Rubenstein
Senior Counsel

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[4] This response supersedes NTO, Inc. (pub. avail. May 23, 1979) (staff unable to agree that a fund's principal place of business was Puerto Rico when, among other things, investment decisions would be made by a non-Puerto Rico investment adviser, and 80% of the fund's assets would be invested in non-Puerto Rico securities traded on non-Puerto Rico securities exchanges).

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Investment Company Act of 1940
Section 6(a)(1)

January 10, 1997

Office of Chief Counsel
Division of Investment Management
Securities and Exchange Commission
450 Fifth Street, N.W.
Judiciary Plaza
Washington, D.C. 20549

Attention: John O'Hanlon, Esq.

Re: Puerto Rico Balanced Fund, Inc.

Ladies and Gentlemen:

We are writing in connection with the proposed organization of the Puerto Rico Balanced Fund, Inc. (the "Fund"), to request that the Division of Investment Management (the "Division") confirm that it will not recommend enforcement action to the Securities and Exchange Commission (the "Commission") if the Fund offers and sells its securities and conducts its operations in the manner described herein in reliance upon the exemption from registration under the Investment Company Act of 1940, as amended (the "1940 Act"), contained in Section 6(a)(1) thereof. Granting our request will require the following modifications to the requirements first set forth in the no-action letter issued by the Division to Puerto Rico Investors Tax-Free Fund, Inc. ("Puerto Rico Fund I") on October 5, 1994 (the "October 5 Letter"), which is attached hereto: (i) the elimination of the requirement that a specified percentage of the Fund's assets be invested in Puerto Rico securities; and (ii) the elimination of the requirement that transactions in such securities be conducted with Puerto Rico broker-dealers.

Section 6(a)(1) exempts from 1940 Act registration any issuer organized and having its principal office and principal place of business in Puerto Rico, provided that the issuer's securities are not offered or sold to United States citizens who are not residents of Puerto Rico. As described more fully below, we believe the proposed structure of the Fund meets the requirements of Section 6(a)(1).

FACTS

A. The Fund

The Fund, like Puerto Rico Fund I and several subsequently organized affiliated funds identical or similar to Puerto Rico Fund I (together, the "Existing Puerto Rico Funds"), will be organized as a Puerto Rico corporation and will register with the Office of the Commissioner of Financial Institutions of Puerto Rico as a non-diversified closed-end or open-end management investment company under the Investment Companies Act of Puerto Rico, Act No. 6 of October 19, 1954, as amended. The Fund's principal office will be located in Puerto Rico. As required under Puerto Rico law, the official books and records of the Fund will be maintained in Puerto Rico and, as noted below, a majority of the Fund's officers and directors will be Puerto Rico residents. In addition, the Fund's board meetings and any shareholder meetings will take place in Puerto Rico.

As explained in more detail below, the Fund will invest in corporate and municipal debt securities, as well as equity securities, including common and preferred stock, of various issuers. The issuers of those securities may be organized both within and outside of Puerto Rico. The Fund also may enter into various types of other transactions with counterparties within and outside of Puerto Rico. These transactions include, for example, repurchase agreements, reverse repurchase agreements and interest rate and other swaps.

The Fund's investment objective and, accordingly, its portfolio composition, will differ from that of the Existing Puerto Rico Funds. The investment objective of each of the Existing Puerto Rico Funds (in the case of the fifth Existing Puerto Rico Fund, one of two investment objectives) is to achieve a high level of current income that is exempt from federal and Puerto Rico income taxes, consistent with the preservation of capital. The Existing Puerto Rico Funds, which invest primarily in debt securities, invest at least 67% of their total assets in securities issued by the Commonwealth of Puerto Rico and its political subdivisions, Puerto Rico mortgage-backed securities and other Puerto Rico tax-exempt securities (the "Puerto Rico Obligations"). (Although the October 5 letter contemplates a 70% requirement, the Existing Puerto Rico Funds now adhere to a 67% limit in reliance on a subsequent no-action letter granted to Merrill Lynch Puerto Rico Tax-Exempt Fund, Inc. on May 26, 1995.)

In contrast, the Fund will seek to achieve both capital appreciation and current income exempt (in whole or in part) from Federal and Puerto Rico income taxes. The Fund will invest a substantial portion of its assets in equity securities, primarily common stock, to achieve capital appreciation. It also may invest in equity securities consisting of preferred stock for income purposes. However, it is anticipated that the Fund will seek to achieve current income primarily through investment in various types of debt securities.

While it is intended that the Fund will purchase securities of Puerto Rico issuers whenever it is prudent to do so, the Fund will require the maximum flexibility to invest particularly in equity securities of issuers domiciled outside of Puerto Rico in order to meet its investment objective.[1] The Fund will also invest in corporate and other debt securities of non-Puerto Rico issuers.

Similarly, the Fund will engage in transactions, such as repurchase agreements, reverse repurchase agreements and swaps for hedging and other purposes, with counterparties located outside of Puerto Rico where those counterparties offer favorable terms. For example, the Fund may enter into interest rate swap agreements with non-Puerto Rico entities. The Fund intends to use these transactions to hedge its portfolio securities and Debt Securities, as defined below, and not as a speculative investment.

The Fund intends to conduct its portfolio securities and other transactions with Puerto Rico broker-dealers wherever possible, subject to best price and execution. However, given that many of the Fund's securities, including securities of some Puerto Rico issuers, will be traded outside of Puerto Rico, and that non-Puerto Rico counterparties often offer the most favorable terms on certain types of transactions, it would be impractical to require the Fund to conduct a minimum percentage of transactions with Puerto Rico broker-dealers.

B. The Fund's Service Providers

Investment Advisory Arrangements. As is the case with the Existing Puerto Rico Funds, the Fund's portfolio investments will be managed by PaineWebber Incorporated of Puerto Rico ("PaineWebber Puerto Rico"), alone or jointly with another Puerto Rico financial institution (together, the "Investment Advisers"). PaineWebber Puerto Rico is a broker-dealer registered under the Securities Exchange Act of 1934, as amended (the "1934 Act"), having its sole place of business in Puerto Rico. PaineWebber Puerto Rico, which is a wholly-owned subsidiary of PaineWebber Incorporated, a Delaware corporation, also is incorporated in Puerto Rico.

The Investment Advisers expect to enter into a separate sub-investment advisory agreement with each of one or more United States sub-advisers (the "Sub-Advisers"), one of which may be Mitchell Hutchins Asset Management Inc., an affiliate of PaineWebber Puerto Rico, which would advise primarily with respect to the Fund's equity investments. The retention of the Sub-Advisers is necessary primarily to obtain investment

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[1] Of course, the Fund will comply with any applicable investment requirements imposed by Puerto Rico law. For purposes of our request, however, the Division should assume that no such requirements are applicable.

expertise with respect to equity and corporate debt securities of non-Puerto Rico issuers.

With respect to certain matters, such as the selection of specific equity securities (and possibly, corporate debt securities), the Sub-Advisers will have full investment discretion, although they will be accountable to the Investment Advisers and, ultimately, the Fund, for these decisions. In other areas, the Sub-Advisers will act in a more consultative role. For example, it is expected that the Sub-Advisers will provide information and advice concerning such matters as general economic conditions and overall asset allocation and other security-specific advice. This consultative advice, while substantively valuable to the Investment Advisers, will be non-binding on the Investment Advisers and the Fund. Thus, the Investment Advisers will have sole authority for making investment decisions for the Fund as to all other securities and related transactions, as they do for the Existing Puerto Rico Funds.

Administrative Arrangements. As is the case with the Existing Puerto Rico Funds, a Puerto Rico financial institution will act as administrator (the "Administrator") for the Fund. This entity will have full responsibility to assure that the Fund is provided with such services as (i) preparing the Fund's financial statements and coordinating with the Fund's outside auditors in connection with their annual audit, (ii) monitoring and assisting in the Fund's compliance with all applicable laws and regulations, and (iii) calculating the Fund's expense accruals.

The portfolio investments of the Fund will be valued in Puerto Rico by the Administrator with the assistance of the Investment Advisers and the Sub-Advisers, as is the case with the Existing Puerto Rico Funds. The net asset value of the common stock (the "Common Stock") issued by the Fund will be calculated in Puerto Rico, and payments to other service providers will be made from within Puerto Rico. The official records of the Fund must, under Puerto Rico law, and will be maintained by the Fund in Puerto Rico.

Custodial and Transfer Agency Arrangements. The investments of the Fund (other than those held in book-entry form including, among others, those that are eligible for deposit with The Depository Trust Company ("DTC")) will be physically held by a custodian bank (the "Custodian") located in Puerto Rico. The same or another Puerto Rico financial institution (the "Transfer Agent") also will act as transfer agent for the Fund, as is the case with the Existing Puerto Rico Funds. Transfer agency functions will include, for example, (i) issuing and recording the appropriate number of shares of Common Stock as authorized and holding such shares in the appropriate shareholder account; (ii) effecting transfers of shares of Common Stock by the registered owners thereof upon receipt of appropriate documentation issued by the Fund; (iii) preparing and

transmitting payments for dividends and distributions declared by the Fund; (iv) acting as agent for shareholders pursuant to any dividend reinvestment plan of the Fund; and (v) issuing replacement certificates for those certificates alleged to have been lost, stolen or destroyed. The Transfer Agent will perform similar functions with respect to any debt securities issued by the Fund.

Auditing Arrangements. Fund audits will be conducted by Puerto Rico resident partners/managers of a nationally recognized public accounting firm with operations in Puerto Rico.

C. Securities Issued by the Fund

The Fund proposes to issue the Common Stock and debt securities, such as commercial paper and medium-term notes (the "Debt Securities" and, together with the Common Stock, the "Securities"). Both types of Securities will be offered and sold only to residents of Puerto Rico, as described below.[2] For purposes of the discussion herein, entities having their principal office and principal place of business located in Puerto Rico are referred to as residents of Puerto Rico.

Because of the tax advantages of the Fund, which are available only to Puerto Rico residents, and the mix and types of portfolio securities it owns, the Fund would not, as an economic matter, be a suitable investment vehicle for anyone other than residents of Puerto Rico. Dividends or interest generated from an investment in the Fund will only be exempt from Puerto Rico and United States income tax in the hands of individuals residing in Puerto Rico and entities organized in Puerto Rico or elsewhere outside of the United States with their principal place of business in Puerto Rico.[3]

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[2] As noted above, the Fund proposes to enter into swaps, repurchase and reverse repurchase agreements with entities that are not residents of Puerto Rico. We believe that these transactions should not be deemed to violate the requirements of Section 6(a)(1) of the 1940 Act.

[3] Under Section 933 of the Internal Revenue Code of 1986, as amended (the "Code"), the Puerto Rico source income of individuals who are bona fide residents of Puerto Rico during the entire taxable year in which dividends or interest is earned is not subject to United States income tax. Also, the Puerto Rico source income of Puerto Rico or non-United States juridical persons generated by their operations in Puerto Rico is not effectively connected with a trade or business conducted in the United States and, as such, is not subject to United States income tax. See Code Sections 871(b), 882(a) and 864(c)(4)(A). Interest payments made by the Fund will constitute Puerto Rico source income,

(continued...)

The Securities will be offered exclusively to individuals who have their principal residence in Puerto Rico, and to persons, other than individuals, whose principal office and principal place of business are located in Puerto Rico, and the prospectuses offering the shares of Common Stock and the Debt Securities (each a, "Prospectus") will so state.[4] In addition, as will be stated in each Prospectus and in a legend on the certificates for the Securities, such Securities may be sold, pledged, hypothecated or otherwise transferred only to Puerto Rico residents. Each Prospectus also will inform those investors who cease to be residents of Puerto Rico of their obligation to liquidate their investment in the Fund as soon as it is economically feasible to do so. While the Fund acknowledges that it is uncertain how such an obligation may be enforced, it is worth noting that investors who no longer reside in Puerto Rico will no longer have available the tax benefits that make the Fund an attractive investment.

The initial offering of Common Stock will be conducted by one or more underwriters, each of which will be a resident of Puerto Rico. The underwriters will include PaineWebber Puerto Rico and BP Capital Markets, Inc. ("BP Capital Markets"), a subsidiary of Banco Popular de Puerto Rico, which is a financial institution chartered and having its principal office and place of business in Puerto Rico. BP Capital Markets is a broker-dealer registered under the 1934 Act that has its sole place of business in Puerto Rico. The secondary market for shares of Common Stock will be made solely by broker-dealers resident in Puerto Rico, including PaineWebber Puerto Rico and BP Capital Markets. Thus, neither the issuance of, nor trading in, shares of Common Stock will have a nexus to the United States or anywhere else outside of Puerto Rico.

The Debt Securities of the Fund will be designed to produce income that is exempt (in whole or in part) from United States and Puerto Rico income taxes for eligible investors. Accordingly, the Debt Securities will be offered, sold or transferred solely to residents of Puerto Rico. Such sales and transfers also will be made solely by broker-dealers residents in Puerto Rico, including PaineWebber Puerto Rico and BP Capital Markets.

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[3](...continued)
pursuant to the interplay between Section 861(a)(1) and Section 1.863-6 of the regulations promulgated under the Code.

[4] The above requirements must be met for the Fund to comply with the intra-state offering exemption from registration under the Securities Act of 1933, as amended (the "1933 Act"), provided by Section 3(a)(11) of the 1933 Act and Rule 147 thereunder.

The foregoing describes the proposed operations of the Fund. The issues that are the subject of the instant request involve: (i) the retention of one or more United States entities as sub-advisers; (ii) whether the Fund should be restricted in its ability to invest in securities of non-Puerto Rico issuers and enter into various types of transactions with non-Puerto Rico counterparties; and (iii) whether the Fund's portfolio securities and other transactions need to be conducted with Puerto Rico broker-dealers. For the reasons set forth more fully below, we believe that the Fund may properly rely on Section 6(a)(1) notwithstanding the retention of a United States sub-adviser and the elimination of restrictions on portfolio securities and other transactions. We further believe that while the operations of the Fund present a particularly compelling case for granting this request, the same conclusion should extend to other funds having a similar Puerto Rico nexus (e.g., the Existing Puerto Rico Funds), regardless of their investment objectives.

DISCUSSION

I. Section 6(a)(1) of the 1940 Act

Section 6(a) of the 1940 Act provides in relevant part that:

> The following investment companies are exempt from the provisions of [the 1940 Act]:
>
> > (1) Any company organized or otherwise created under the laws of and having its principal office and place of business in Puerto Rico, the Virgin Islands, or any other possession of the United States; but such exemption shall terminate if any security of which such company is the issuer is offered for sale or sold after the effective date of [the 1940 Act], by such company or an underwriter therefor, to a resident of any State other than the State in which such company is organized.

We believe that the Fund should be viewed as meeting the requirements of Section 6(a)(1) of the 1940 Act. As described above, the Fund is incorporated and has its principal office in Puerto Rico, and should be viewed as having its principal place of business in Puerto Rico.

A. Retention of Sub-Advisers Outside of Puerto Rico

We believe that the fact that sub-advisory services may be provided to the Fund by one or more entities located outside of Puerto Rico (e.g., in the United States) does not change the Fund's essential nature as a Puerto Rico enterprise. To put the

role of the Sub-Advisers in context, it is worthwhile to again identify the extensive contacts of the Fund and its service providers with Puerto Rico. Those contacts are: (1) the Fund will be incorporated and have its principal office in Puerto Rico, and will maintain its official books and records in Puerto Rico, (2) PaineWebber Puerto Rico, a Puerto Rico corporation doing business solely in Puerto Rico, and possibly another Puerto Rico financial institution will act as investment adviser(s) to the Fund, (3) a Puerto Rico financial institution will enter into an administration agreement with the Fund pursuant to which it will provide all aspects of Fund administration, (4) the Fund will be registered and regulated as an investment company under Puerto Rico law, (5) the Fund will be designed to maximize tax benefits for Puerto Rico residents, to the extent consistent with its overall investment objective, (6) the Custodian will hold all Fund assets in Puerto Rico, other than those held in book-entry form, including DTC-eligible securities, (7) the Administrator will value the Fund's assets in Puerto Rico, (8) a majority of the Fund's officers and directors will be Puerto Rico residents, (9) the shares of Common Stock of the Fund, as well as its Debt Securities, will be sold by Puerto Rico underwriters solely to Puerto Rico residents, (10) the secondary market for the Common Stock and the Debt Securities will be maintained in Puerto Rico, (11) neither such Common Stock nor the Debt Securities may be transferred to any person that is not a resident of Puerto Rico, (12) investors in the Fund will be made aware of their obligation to liquidate their investment in the Fund if they cease to be residents of Puerto Rico, when such liquidation becomes economically feasible, (13) the Fund's Transfer Agent will be a Puerto Rico entity, (14) Fund audits will be conducted by Puerto Rico resident partners/managers of a nationally recognized public accounting firm with operations in Puerto Rico, and (15) the Fund's board meetings and any shareholder meetings will take place in Puerto Rico. We believe that these contacts demonstrate that the Fund is fundamentally a Puerto Rico entity, its principal place of business is Puerto Rico and it is doing business in Puerto Rico.

The Division has issued very few no-action letters regarding Section 6(a)(1). Nevertheless, direct support for advisory services, with full investment discretion, being rendered outside of Puerto Rico may be found in Merrill Lynch Puerto-Rico Tax-Exempt Fund, Inc. (pub. avail. May 26, 1995) ("Merrill Lynch Puerto Rico"). In Merrill Lynch Puerto Rico, the Division granted a no-action request under Section 6(a)(1) to an open-end, non-diversified Puerto Rico investment company (the "Company"). The Company intended to retain a United States investment adviser, although it would employ Puerto Rico entities for administration, transfer agency and custodian services.

As mentioned above and unlike the situation in the Merrill Lynch Puerto Rico letter, in which the United States investment adviser made all investment decisions, the Sub-Advisers in the instant case will have investment discretion solely with respect to equity securities and, possibly, corporate

debt securities. The Puerto Rico-based Investment Advisers will have sole investment discretion as to all of the Fund's other securities. We believe that since the Division has allowed the retention of a United States adviser with investment discretion with respect to all investments, the retention of one or more United States sub-advisers with investment discretion only with respect to equity and corporate debt investments of the Fund, a fortiori, should pose no disqualification for the exemption provided by Section 6(a)(1) of the 1940 Act.[5]

We recognize that the Company in the Merrill Lynch Puerto Rico letter agreed to invest at least 67% of its total assets in Puerto Rico Obligations and to conduct portfolio transactions involving Puerto Rico Obligations with Puerto Rico broker-dealers. However, we do not believe those facts are required by Section 6(a)(1). We believe this proposition is supported by analogous no-action responses in the offshore fund area. While those responses involve Section 7(d) of the 1940 Act, rather than Section 6(a)(1), they involve a similar issue of whether a fund organized outside of the United States has sufficient United States contacts as to require registration under the 1940 Act.[6]

The Division has issued several no-action letters to the effect that registration of an offshore fund is not required despite the existence of a United States investment adviser and

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[5] Additional support for certain advisory services being rendered outside of Puerto Rico may be found in Innerspace Medical Capital Corp. (pub. avail. July 21, 1992) ("Innerspace"). The Innerspace letter involved a Puerto Rico corporation (the "Corporation") organized to qualify as an "investment capital fund" under Puerto Rico law and which was to invest entirely in securities issued by a Delaware corporation that had agreed to use the proceeds of the Corporation's investment to establish a manufacturing facility in Puerto Rico. The Corporation obtained no-action assurance and was deemed to have its principal place of business in Puerto Rico, notwithstanding that it retained a United States corporation to provide certain necessary investment expertise. The October 5 Letter itself also offered partial support by permitting retention of a United States sub-adviser on a consultative basis.

[6] Section 7(d) generally provides:

> No investment company, unless organized or otherwise created under the laws of the United States or of a State, and no depositor or trustee of or underwriter for such a company not so organized or created, shall make use of the mails or any means or instrumentality of interstate commerce, directly or indirectly, to offer for sale, sell, or deliver after sale, in connection with a public offering, any security of which such company is the issuer...

administrator, even when there are investments in securities of United States issuers and United States broker-dealers may be used. For example, the Division issued such a no-action letter in Shearson International Dollar Reserves (pub. avail. July 15, 1981), where a Luxembourg open-end fund having a Luxembourg manager and investing primarily in United States dollar-denominated money market instruments including, among other things, certificates of deposit of United States and non-United States banks and interest-bearing deposits therein, had a United States investment adviser, administrator, sub-custodian and distributor. Similarly, in Merrill Lynch & Co., Inc. (pub. avail. May 12, 1986), the Division issued a positive no-action letter response with respect to non-United States open-end funds, notwithstanding the existence of a United States investment adviser and custodian. But see NTO, Inc. (pub. avail. May 23, 1979) ("NTO, Inc."), in which the Division determined that Section 6(a)(1) was unavailable to a Puerto Rico-incorporated investment company designed to invest in securities traded in markets outside of Puerto Rico, and whose investments were determined by a United States investment adviser and held by a United States custodian.

The Fund in the instant situation will have fewer United States contacts than any of the above funds. It will have a Puerto Rico resident entity performing all of the Fund's day-to-day administrative and transfer agency functions in Puerto Rico. The Fund also will have solely Puerto Rico underwriters, and have custody of all of its assets, other than those that are eligible for book-entry, in Puerto Rico.

In addition, we note by analogy that under Section 864(b)(2)(A)(ii) of the Code, the principal office of an investment company is not determined by the location of its investment adviser or the nature of its investments. Thus, such a company may, despite the existence of a United States sub-adviser and United States investments, be deemed to have its principal office outside the United States. Under this Code provision, a corporation that performs "all or a substantial portion" of ten functions (the "ten factors" or "ten commandments") at an office or offices outside of the United States is considered to have its principal office outside the United States.[7]

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[7] The ten functions are:

(i) communicating with its shareholders (including the furnishing of financial reports); (ii) communicating with the general public; (iii) soliciting sales of its own stock; (iv) accepting the subscriptions of new stockholders; (v) maintaining its principal corporate records and books of account; (vi) auditing its books of account; (vii) disbursing payments of dividends, legal fees, accounting fees and officers' and directors' salaries; (viii)

(continued...)

In evaluating whether a corporation's activities fit within the safe harbor, the activities performed by its agents and service providers are taken into account. We submit that just as the Fund would thereby be deemed to have its principal office in Puerto Rico and not the United States for purposes of the Code, the Fund should be viewed as having its principal place of business in Puerto Rico for purposes of Section 6(a)(1).[8]

B. Requirements as to Portfolio Securities and Other Transactions and the Use of Puerto Rico Broker-Dealers

While investors in the Existing Puerto Rico Funds will also benefit if all of the percentage limitations on the Fund's assets described in the October 5 Letter were removed, the removal of those limitations is imperative for the successful operation of the proposed Fund. As described above, the Fund will seek to achieve current income and capital appreciation. The Fund, therefore, will invest in equity securities, as well as in a wider variety of types of debt securities, than the Existing Puerto Rico Funds. While it is intended that the Fund will purchase equity and debt securities of Puerto Rico issuers whenever it is prudent to do so, the Fund will require the maximum flexibility to meet its investment objective. In addition, the elimination of percentage limitations would avoid the necessity for the difficult task of defining precisely the concept of a "Puerto Rico Issuer" in the context of a company issuing corporate debt or equity securities. In that regard, we note that there are relatively few public companies in Puerto Rico in which the Fund could invest, and those that exist tend to be concentrated in financial services. Consequently, we believe it is important that the Fund not be required to invest any minimum percentage of its assets in securities of Puerto Rico issuers.

As a corollary, we request that the Fund be exempt from the requirement of the October 5 Letter that a corresponding 67% percent of the Fund's investment transactions be conducted with Puerto Rico broker-dealers. Given that many of the Fund's securities, including securities of some Puerto Rico issuers,

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[7](...continued)
publishing or furnishing the offering and redemption price of the shares of stock issued by it; (ix) conducting meetings of its shareholders and board of directors; and (x) making redemptions of its own stock.

[8] The Existing Puerto Rico Funds are foreign corporations under Section 7701 of the Code, and because they satisfy the "ten factor" test under Section 864(b)(2)(A)(ii) of the Code, they are not subject to United States federal income tax on their net income. Thus, they are taxed like offshore funds.

will be traded outside of Puerto Rico, the above requirement should be eliminated, particularly in light of the need to obtain best price and execution.[9] Similarly, the Fund intends to enter into other transactions with Puerto Rico counterparties when the terms of those transactions are advantageous to the Fund.

With regard to the foregoing requests, we do not believe it is necessary under Section 6(a)(1) for the Fund to invest in securities of Puerto Rico issuers, enter into a minimum amount of transactions with Puerto Rico entities, or use Puerto Rico broker-dealers to any specified degree. As the above-mentioned no-action responses involving Section 7(d) of the 1940 Act indicate, the registration of an offshore fund is not required despite the potential for unlimited investments in securities of United States issuers or transactions with United States broker-dealers or other entities. Furthermore, as indicated above, the "ten factor" test has no provision that a corporation invest in securities of non-United States issuers or conduct trades offshore in order for it to be deemed to have its principal office outside the United States. In fact, Section 864(b)(1)(A) of the Code states that trading in stocks or securities through a broker in the United States is not a trade or business in the United States.

In addition, the Commission staff appears to have taken a similar view in the context of commodities vehicles relying on the intrastate offering exemption of Rule 147 under the 1933 Act. See, e.g., C.S. Trading Partnership No. 2 (pub. avail. May 7, 1981) ("C.S. Trading"); Gem Foods, Inc. (pub. avail. August 15, 1977). But see Eugene T. Ichinose, Jr. (pub. avail. February 15, 1979). In C.S. Trading, the Division of Corporation Finance permitted a Pennsylvania partnership, among other things, to trade commodities futures through an out-of-state broker on exchanges located outside of Pennsylvania.[10] Similarly, we submit that it is not necessary under Section 6(a)(1) to require that a minimum percentage of the Fund's investments be in securities of Puerto Rico issuers.

Finally, we wish to reemphasize that notwithstanding any relaxation of the above restrictions, the Fund's tax benefits are available only to persons who are residents of Puerto Rico. In that regard, the Fund is designed to provide Puerto Rico

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[9] The Fund intends, however, to conduct its portfolio transactions with Puerto Rico broker-dealers wherever possible, subject to best price and execution.

[10] There was, however, a limit on the percentage of the net offering proceeds that the partnership could place with the out-of-state broker to satisfy margin requirements. While it is not clear, the no-action letters seem to indicate that such a limitation is intended to address the location of assets rather than the nature of the partnership's portfolio transactions.

investors with current income, including income exempt (or partially exempt) from Puerto Rico and Federal income tax (and capital appreciation). Therefore, we understand that the Fund, like the Existing Puerto Rico Funds, will be exclusively tailored to the Puerto Rico market, will be attractive as an investment vehicle solely to investors who are residents of Puerto Rico and will be sold only to Puerto Rico residents.

CONCLUSION

We respectfully submit that the Fund should qualify for the exemption provided by Section 6(a)(1) of the 1940 Act, notwithstanding the proposed retention of a non-Puerto Rico entity as sub-adviser, the elimination of percentage requirements as to the Puerto Rico nature of the Fund's investment and other transactions and the elimination of the requirement that such transactions be conducted with Puerto Rico broker-dealers. The Fund will have numerous and substantial contacts with Puerto Rico such as to make it readily apparent that the Fund's principal place of business is located in Puerto Rico for purposes of Section 6(a)(1). As required by Section 6(a)(1), the Fund will sell its Securities only to Puerto Rico residents, and these Securities may subsequently be transferred only to qualified persons.

We appreciate your prompt attention to this request. If you have any comments or questions, please feel free to call either Brian M. Kaplowitz ((212) 839-5370) or Susan Mattisinko ((212) 839-5428) of Brown & Wood LLP or Victoria E. Schonfeld ((212) 713-8853) of Mitchell Hutchins Asset Management Inc.

Very truly yours,

Brown & Wood LLP