

MEMO# 8485

December 20, 1996

SEC PROPOSES RULES REGARDING PRIVATE INVESTMENT COMPANIES

1 See Investment Company Act Release No. 22405 (December 18, 1996) ("Release").
December 20, 1996 TO: INVESTMENT ADVISERS COMMITTEE No. 29-96 SEC RULES
COMMITTEE No. 134-96 RE: SEC PROPOSES RULES REGARDING PRIVATE INVESTMENT
COMPANIES

The Securities and Exchange Commission recently proposed for public comment several new rules under the Investment Company Act of 1940.¹ The proposed rules relate to the new exception for private investment companies that consist solely of certain financially sophisticated persons or so-called "qualified purchasers" ("Qualified Purchaser Pools") and to private investment companies that are beneficially owned by not more than one hundred persons ("Section 3(c)(1) funds"). The rules would implement certain provisions of the National Securities Markets Improvement Act of 1996 ("1996 Act"), which was enacted on October 11, 1996. Definition of the term "Investments" Under the 1996 Act, qualified purchasers are deemed to be, among others, natural persons that own not less than \$5 million in investments and other persons that own and invest on a discretionary basis not less than \$25 million in investments. The 1996 Act directed the SEC to define the term "investments." Under the SEC's proposal, investments generally would be defined as securities and real estate, futures contracts, commodity interests, physical commodities, cash and cash equivalents held for investment purposes. The proposed rule would exclude certain assets from being deemed investments, including controlling ownership interests in certain businesses and real estate used for personal purposes. According to the Release, the definition is intended to include assets held for investment purposes and assets that indicate a significant degree of investment experience such that the investor can be expected to have the knowledge to evaluate the risk of investing in unregulated pools. Comment is specifically requested on whether certain types of securities should be excluded from the definition of investments because they do not serve as an appropriate measure of investment experience. Comment is also specifically requested on whether real estate should only be included as an investment under the rule if the investment is in the form of a security. Comment is also requested on whether cash should only be included as an investment if it is in excess of a certain amount. The proposed rule would allow investments to be valued at cost or market value and would require certain deductions to be made, including any outstanding indebtedness incurred to acquire investments. In addition, certain other amounts received during the preceding twelve months that do not reflect investment experience, such as amounts received pursuant to an insurance policy or as gifts, would be required to be deducted from a person's investments. Comment is requested on whether the twelve month period is sufficient to establish that a person has the requisite financial sophistication. Conversion of a Section 3(c)(1) Fund into a Qualified Purchaser Pool The 1996 Act conditionally permitted certain existing Section 3(c)(1) funds

to convert into Qualified Purchaser Pools without requiring investors that are not qualified purchasers to dispose of their interests in the fund ("Grandfathered Funds"). Specifically, any Grandfathered Fund, prior to the conversion, must make certain disclosures to beneficial owners and provide them with an opportunity to redeem their interests in the fund. The 1996 Act directed the SEC to define "beneficial owner" for purposes of this provision. According to the Release, Congress intended the SEC to use this authority to address any unnecessary burdens that might arise if funds were required to provide the disclosure and opportunity to redeem to the underlying owners of an institutional investor. (Such a result would have been possible if Section 3(c)(1)s "look through" provisions were applied to institutional investors.) The proposal would provide that securities of a Grandfathered Fund beneficially owned by a company would be deemed to be beneficially owned by one person unless certain specific conditions apply. The proposal also would provide a non-exclusive safe harbor for any Grandfathered Fund from being integrated with a newly formed Section 3(c)(1) fund if, at the time that the new Section 3(c)(1) fund offers its securities, 25% or more of the value of all securities of the Grandfathered Fund is held by qualified purchasers that acquired these securities after October 11, 1996. The SEC, in proposing this safe harbor, was responding to requests for clarification of the 1996 Acts non-integration provision. Comment is requested on whether the percentage threshold should be higher (e.g., 50%).

Proposed Transition Rule Regarding Section 3(c)(1) Funds The 1996 Act amended Section 3(c)(1) of the Investment Company Act to eliminate one of two tests applied to Section 3(c)(1) funds to determine whether to "look through" and count the underlying shareholders of a corporate investor for purposes of Section 3(c)(1)s one hundred person limit. Under the proposal, the amended look through provision would not apply in the case of an investor that held more than 10% of the outstanding voting securities of a Section 3(c)(1) fund on the date of the 1996 Acts enactment, provided that the investor continues to satisfy pre-amendment Section 3(c)(1). According to the Release, some existing Section 3(c)(1) funds may have investors that own 10% or more of the Section 3(c)(1) fund in reliance on the pre-amendment application of the look-through provision, and the proposal is designed to permit the continuance of those relationships.

Investments by Certain Employees of Private Investment Companies Under the proposal, directors, executive officers, general partners, and certain knowledgeable employees of a Section 3(c)(1) fund or of an affiliated person of the fund would be permitted to acquire securities of the fund without being counted against the one hundred person limit. The proposal also would permit these personnel of a Qualified Purchaser Pool to invest in that pool even if they did not meet the definition of qualified purchaser. The 1996 Act directed the SEC to permit such investments by "knowledgeable" employees of these funds. Comment is requested on whether the proposed rule should contain any other criteria for identifying knowledgeable employees (e.g., the employees salary level or the amount of investments owned.) The SEC also seeks comment on whether the proposed rule should contain any other requirements, particularly with respect to investments that are made by fund personnel through certain pension plans.

Certain Transfers To address situations in which a Section 3(c)(1)s one hundred investor limit was exceeded because of transfers which are neither within the issuers control nor are voluntary on the part of the present beneficial owner, Section 3(c)(1)(B) of the Investment Company Act provides that beneficial ownership of securities of a Section 3(c)(1) fund by any person who acquires the securities as a result of a "legal separation, divorce, death, or other involuntary event" will be deemed to be beneficial ownership by the person from whom the transfer was made, pursuant to such rules and regulations as the SEC prescribes. The 1996 Act directed the SEC to prescribe rules to implement Section 3(c)(1)(B). As proposed by the SEC, beneficial ownership by a person ("transferee") who acquired securities of a Section 3(c)(1) fund pursuant to a gift, bequest, or an agreement relating to a legal separation or divorce or

other involuntary event will be deemed to be beneficial ownership by the person from whom the transfer was made ("transferor") if transferees are limited to family members of the transferor, trusts or similar vehicles established by the transferor for the exclusive benefit of family members, and charitable organizations. The proposal also would provide that the securities of the Section 3(c)(1) fund must have been acquired by the transferor pursuant to, or are otherwise subject to, an arrangement prohibiting any other transfers, except transfers back to the fund. The proposal also would permit transfers of interests in Qualified Purchaser Pools to persons that are not qualified purchasers under essentially the same conditions. A copy of the Commissions release proposing the rules is attached. Comments are due on the proposal by February 10, 1997. Please contact me with your comments on the proposal no later than January 15, 1997. You can reach me by phone at 202/326-5821, fax at 202/326-5827 or e-mail at donohue@ici.com. 4Dorothy M. Donohue
Assistant Counsel Attachment

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