The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

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SEC PROPOSES RULES REGARDING PRIVATE INVESTMENT COMPANIES

1 See Investment Company Act Release No. 22405 (December 18, 1996) ("Release"). December 20, 1996 TO: BOARD OF GOVERNORS No. 62-96 INVESTMENT ADVISER ASSOCIATE MEMBERS No. 48-96 SEC RULES MEMBERS No. 82-96 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. 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. 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, prior to any such conversion, a Grandfathered Fund 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 Act*s non-integration provision. Proposed Transition Rule Regarding Section 3(c)(1) Funds 2The 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 Act*s 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. Certain Transfers To address situations in which a Section 3(c)(1)*s one hundred investor limit would be exceeded because of transfers which are neither within the issuer*s 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. Dorothy M. Donohue Assistant Counsel Attachment Note: Not all recipients of this memo will receive an attachment. If you wish to obtain a copy of the attachment referred to in this memo, please call the Institute’s Information Resource Center at (202)326-8304, and ask for this memo’s

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