

**MEMO# 8791**

April 10, 1997

## **SEC ADOPTS RULES REGARDING PRIVATE INVESTMENT COMPANIES**

\* See Investment Company Act Release No. 22597 (April 3, 1997) ("Release"), [62 FR 17512 (April 9, 1997)]. April 10, 1997 TO: BOARD OF GOVERNORS No. 27-97 INVESTMENT ADVISER MEMBERS No. 11-97 SEC RULES MEMBERS No. 29-97 RE: SEC ADOPTS RULES REGARDING PRIVATE INVESTMENT COMPANIES

The Securities and Exchange Commission recently adopted several new rules under the Investment Company Act of 1940.\* The 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, which are summarized below, would implement certain provisions of the National Securities Markets Improvement Act of 1996 ("1996 Act"). No Public Offering Requirement Section 3(c)(7) prohibits any Qualified Purchaser Pool from making or proposing to make a public offering of its securities. Consistent with the Institutes recommendations, the Commission made clear in the Release that Section 3(c)(7)s no public offering requirement should be interpreted in the same manner as the limitation in Section 3(c)(1). (Section 3(c)(1)s limitation on public offerings has been interpreted to permit "transactions by an issuer not involving any public offering" under Section 4(2) of the Securities Act of 1933.) SEC Definition of "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." Rule 2a51-1 under the Investment Company Act defines investments as certain securities, financial contracts entered into for investment purposes, real estate held for investment purposes, commodity interests held for investment purposes, physical commodities held for investment purposes, cash and cash equivalents held for investment purposes, and bank deposits, certificates of deposit, bankers acceptances and similar bank instruments held for investment purposes. Consistent with the proposal and the Institutes recommendations, real estate used for personal purposes, jewelry, artwork, antiques and other collectibles are not considered to be investments. Unlike the proposal, rule 2a51-1 provides that, with two exceptions, qualified institutional buyers ("QIBs"), as defined in Rule 144A under the Securities Act, will be deemed to be qualified purchasers. The first exception relates to dealers. In order to coordinate the definition of QIB with the statutory definition of qualified purchaser, rule 2a51-1 requires a dealer to own and invest on a discretionary basis \$25 million of QIB securities (rather than Rule 144As \$10 million of QIB securities). The second exception relates to employee benefit plans and is consistent with the Institutes recommendations regarding the treatment of employee benefit plans

under the new rules. Under rule 2a51-1, self-directed employee benefit plans, including 401k plans, are not considered to be qualified purchasers for purposes of rule 2a51-1. Rather, an employee could invest in a qualified purchaser pool through a self-directed plan only if the employee is a qualified purchaser. Rule 2a51-1(d) allows investments to be valued at cost or fair market value on the most recent practicable date. In addition, as recommended by the Institute, deductions are required to be made for outstanding indebtedness incurred to acquire investments. In a change from the proposal, 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, will not be required to be deducted from a persons investments. The Commission reasoned that the burdens that might be associated with such deductions appear to outweigh the benefits to investors. Reasonable Belief In a change from the proposal, rule 2a51-1(h) defines qualified purchaser as any person who a Qualified Purchaser Pool or its representative "reasonably believes" is a qualified purchaser. This aspect of the rule conforms to the provisions of other Commission rules under the Securities Act that address transactions involving certain categories of sophisticated investors, such as rule 506 of Regulation D and rule 144A. (The proposal would have permitted a Qualified Purchaser Pool or its representative to rely upon various documentation provided by the prospective qualified purchaser and would have required that reliance on this information be reasonable and that the Qualified Purchaser Pool or its representative, after reasonable inquiry, have no basis for believing that the information is incorrect in any material respect.) Retirement Plans Consistent with the Institutes recommendations, rule 2a51-1(g)(4) provides that a prospective qualified purchaser who is a natural person may include investments held in his or her IRA or other retirement accounts when the prospective qualified purchaser makes all of the investment decisions for the account. Also consistent with the Institutes recommendations, the Commission stated in the adopting release its interpretation of Section 3(c)(7) as it relates to investments in Qualified Purchaser Pools by retirement plans. Specifically, the Commission stated that for retirement plans, such as 401k plans, that allow an employee to direct the investment of his or her account balance to specified investment alternatives available through the plan, a Qualified Purchaser Pool is required to "look through" the 401k plan to its participants for purposes of determining whether each investor in the Qualified Purchaser Pool is a qualified purchaser. The Commission stated that this interpretation is consistent with the legislative history of the 1996 Act which indicates that Qualified Purchaser Pools are to be limited to investors who own a specified amount of investments, and that, therefore, the critical issue is whether the employee owns the requisite amount of investments. Consistent with this approach, a plan trustee or other plan fiduciary that makes investment decisions for a defined benefit or other retirement plan that owns \$25 million of investments and does not permit participants to decide whether or how much to invest in particular investment alternatives would be a qualified purchaser with respect to investments made by the plan trustee. The Release also notes that the Commission is aware that the staff has taken the position under Section 3(c)(1) that a self-directed employee benefit plan can be considered to be a single investor if the plan is operating in a manner resembling that of a defined benefit plan. (See *Standish Ayer & Wood, Inc. Stable Value Group Trust* (Dec. 28, 1995)). The Release notes that the Commission has requested the staff to consider whether the position taken in *Standish Ayer* is appropriate in the context of Section 3(c)(7) and to reconsider whether the position taken in *Standish Ayer* is consistent with a staff letter that required each participant in a retirement plan to be counted as an investor in a Section 3(c)(1) fund. (See *The Panagora Group Trust* (Apr. 29, 1993)). Other Issues Relating to Qualified Purchasers The Commission stated in the Release that, as a general matter, whether a person is a qualified purchaser needs to be determined or reaffirmed each time the person acquires securities of a Qualified Purchaser Pool. The

Institute strongly supported this limitation. The Commission also stated that it would interpret Section 3(c)(7) as not requiring a Qualified Purchaser Pool to determine whether the investor is a qualified purchaser each time the investor makes additional investments in the fund pursuant to a binding commitment to make such payments, provided that the investor was a qualified purchaser at the time the investor made the commitment.

**Conforming Rule** As recommended by the Institute, the Commission adopted rule 2a51-3 under the Investment Company Act which makes clear that a company can not be formed for the specific purpose of acquiring interests in a Qualified Purchaser Pool unless each of the companys beneficial owners is a qualified purchaser. The rule is intended to limit the possibility that a company will be able to do indirectly what it is prohibited from doing directly. In a change from the proposal, the rule has been expanded to permit a company to be a qualified purchaser (even if the company did not own \$25 million in investments) if each beneficial owner of the companys securities is a qualified purchaser.

**Non-Exclusive Safe Harbor for Certain Section 3(c)(7) Funds** The Commission determined not to adopt proposed rule 3c-7 under the Investment Company Act, which would have provided a safe harbor, in response to concerns raised by 4sponsors of private investment companies regarding the ability of a sponsor of a 3(c)(1) fund that undergoes a bona fide conversion into a Qualified Purchaser Pool ("Grandfathered Fund") to then create a new 3(c)(1) fund. Under the proposed rule, the Grandfathered Fund would have been treated as an issuer excluded under section 3(c)(7) if, at the time the new 3(c)(1) fund offers its securities, 25% or more of the value of all securities of the Grandfathered Fund were held by qualified purchasers that acquired these securities after October 11, 1996. The Commission stated that, after further consideration of the issue and after considering the views of commenters, it does not believe that a safe harbor is necessary. Instead, whether a conversion to a Grandfathered Fund is bona fide and undertaken in good faith will depend on all the facts and circumstances. The relevant facts would include, among others, whether the fund has taken steps to sell its securities to qualified purchasers, and whether the fund is subject to legal or other impediments that would preclude it from selling its securities to qualified purchasers.

**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. Consistent with the Institutes recommendations, rule 3c-1 under the Investment Company Act provides that 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 April 1, 1997, provided that the investor continues to satisfy pre-amendment Section 3(c)(1). According to the Release, the Commission recognizes that 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 rule is designed to permit the continuance of those relationships.

**Investments by Certain Employees of Private Investment Companies** Rule 3c-5 under the Investment Company Act provides that directors, executive officers, general partners, and certain knowledgeable employees who participate in the investment activities of a Section 3(c)(1) fund may acquire securities of the fund without being counted against the one hundred person limit. The rule also permits these personnel of a Qualified Purchaser Pool to invest in that pool even if they do not meet the definition of qualified purchaser. As recommended by the Institute, rule 3c-5 would not permit employees who simply "obtain information" regarding the funds investment activities to invest in that fund. In a change from the proposal, employees who are knowledgeable employees because of their participation in investment activities are not required to have been engaged in these activities on behalf of the fund for at least 12 months. Rather, rule 3c-5 includes as

knowledgeable employees those employees who performed substantially similar functions or duties for or on behalf of another person during the preceding 12 months. This change will permit new employees who had equivalent experience with their previous employer to invest in the fund. 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 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 Commission prescribes. The 1996 Act directed the Commission to prescribe rules to implement Section 3(c)(1)(B). Rule 3c-6 under the Investment Company Act provides that 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 will be deemed to be beneficial ownership by the person from whom the transfer was made ("transferor"). Unlike the proposal, rule 3c-6 does not apply to other involuntary transfers and does not require transferees to be 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. Rule 3c-6 permits transfers of interests in Qualified Purchaser Pools to persons that are not qualified purchasers under essentially the same conditions. Effective Dates The rules will become effective on June 9, 1997, which is 60 days after their publication in the Federal Register. The 1996 Acts amendments affecting private investment companies, however, were effective on April 9, 1997. (Under the terms of the 1996 Act, the amendments affecting private investment companies, contained in Section 209 of the 1996 Act and amending parts of Section 2(a), Section 3(a), and Section 3(c) of the Investment Company Act, become effective on April 9, 1997 or "the date on which rulemaking required . . . is completed." We have been informed by the Commission staff that they view rulemaking as being completed on the date the rules were published in the Federal Register -- April 9, 1997.) Dorothy M. Donohue Associate Counsel Attachment (in .pdf format) 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 attachment number: 8791.