UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

DIVISION OF
INVESTMENT MANAGEMENT

July 16, 1992

Marti Cochran
Staff Director and Chief Counsel
Subcommittee on Securities
Committee on Banking, Housing,
and Urban Affairs
534 Dirksen Office Building
United States Senate
Washington, D.C. 20510

Dear Marti:

At your request, the Division of Investment Management has reviewed several proposed amendments recommended by the Investment Company Institute ("ICI") with respect to S. 2518, the "Small Business Incentive Act of 1992." As you know, the Division is providing technical assistance to the Subcommittee in connection with the ICI's proposals; the Commission has not considered these proposals nor has it reviewed or approved the contents of this letter. The ICI's proposals are addressed separately below.

Modification of the Definition of "Qualified Purchaser" in Proposed Section 2(a)(51)

As you know, proposed section 2(a)(51) under the Investment Company Act would define the term "qualified purchaser" for purposes of the new "qualified purchaser" investment pools, which would be excepted from the definition of "investment company" under proposed section 3(c)(7). The proposed section 3(c)(7) exception is premised on the theory that "qualified purchasers" do not need the protections of the Investment Company Act because they are capable of safeguarding their own interests.

Consistent with this objective, the Commission would have the authority under proposed section 2(a)(51) to define by rule the class of "qualified purchasers" eligible to invest in the new section 3(c)(7) issuers; proposed section 2(a)(51) would require the Commission to determine that such purchasers do not need the protections of the Act based on factors (enumerated in proposed section 2(a)(51)) that evidence the purchasers' financial sophistication. The ICI has recommended the addition of a minimum standard in proposed section 2(a)(51) which, in effect, would limit the universe of "qualified purchasers" to those persons who, acting on their own account or the account of other qualified purchasers, own and invest on a discretionary basis at least $100 million in securities of unaffiliated issuers.

The Division believes that codification of the ICI's proposed minimum standard is unnecessary and overly restrictive. Several members of the private investment company industry, for example, have informally advised the Division of the importance of capital participation by high net worth individuals in private funds.[1] The Division, however, knows of only a few individuals that could satisfy the essentially institutional securities management requirement of the ICI's recommendation.[2]

More significantly, the ICI's approach would unnecessarily limit -- if not abrogate -- the Commission's administrative flexibility to respond to changing conditions and the benefit of the public comment process. Codification of the proposed standard runs a significant risk that further legislation will be necessary to effectuate the legislation's goal of increasing capital available for investment in small businesses.

The Division understands that the ICI's proposal reflects a concern that the rulemaking authority provided under proposed section 2(a)(51) may result in investments in excepted section 3(c)(7) pools by persons who do not possess the requisite degree of financial sophistication to appreciate the risks of their investment. While the Division agrees that a high degree of sophistication should be required to invest in the proposed investment vehicles, the Division does not believe that the ICI's concern is justified.

In its Memorandum in Support of the Legislation forwarded to Congress on March 20, 1992, the Commission itself stated that, in exercising rulemaking authority under proposed section 2(a)(51), it "would be particularly sensitive to the risks presented

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[1] As discussed in note 3, the Commission has indicated that sophisticated individuals should be permitted to invest in the new "qualified purchaser" pools.

[2] The ICI's proposal also may unduly restrict the number of institutions that could invest in section 3(c)(7) issuers. This is because the proposed amendment would limit the $100 million securities management requirement to issuers that are *not affiliated* with the qualified purchaser. Under the definition of "affiliated person" in section 2(a)(3) of the Investment Company Act, the term "affiliated person" includes any person that owns, directly or indirectly, five percent of another person's voting securities. Thus, securities holdings of five percent or more could create an affiliation with the issuer which, in turn, would result in the exclusion of the issuer's securities for purposes of the proposed $100 million securities management requirement.

by unregulated investment pools and the breadth of the proposed section 3(c)(7) exception, which would not otherwise be limited."[3] Thus, there is absolutely no indication that the Commission would exercise its authority under proposed section 2(a)(51) in a way that would erode the protections of the Investment Company Act for less sophisticated investors. The Division also would expect the legislative history of proposed section 2(a)(51) to provide appropriate guidance as to Congressional expectations respecting the Commission's authority under proposed section 2(a)(51).

Nonetheless, if the Subcommittee is inclined to modify proposed section 2(a)(51) to address the ICI's concern, the Division believes that steps could be taken short of codification of the ICI's proposal minimum standard. One way (set forth below) would be to revise the factors required to be considered by the Commission under proposed section 2(a)(51).

> "(2)(a)(51) 'Qualified purchaser' means any person whom the Commission, by rule or regulation, has determined does not need the protections of this title. The Commission's determination shall be based on the person's--
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> "(A) high degree of financial sophistication, in consideration of the person's extensive knowledge of and experience in financial matters;
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> "(B) sizeable net worth;
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> "(C) amount of assets owned or under management, which amount must be substantial;
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> "(D) relationship with an issuer; or
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> "(E) such other factors as the Commission may determine to be consistent with the purpose of this paragraph."

<u>Changes to Section 3(c)(1)'s Attribution Provision</u>

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[3] Memorandum of the Securities and Exchange Commission in Support of the Small Business Inventive Act of 1992, page 4. In that Memorandum, the Commission indicated that, at least initially, the definition of "qualified institutional buyer" in rule 144A under the Securities Act of 1933 would represent an appropriate standard for determining the level of sophistication for those institutions investing in proposed section 3(c)(7) issuers. (As you know, the ICI's proposed minimum standard would codify the requirements generally accompanying "qualified institutional buyer" status under rule 144A.) The Commission also has indicated that it would be appropriate to allow natural persons to invest in the new section 3(c)(7) pools, so long as those persons possess a high degree of sophistication comparable to that required of their institutional counterparts. *Id.*

As currently proposed, the attribution, or "look through," provision of section 3(c)(1) of the Investment Company Act would apply to an entity that owns ten percent or more of a section 3(c)(1) issuer's voting securities, where the entity is an investment company or is excepted from the definition of "investment company" under section 3(c)(1) or proposed section 3(c)(7).[4] The attribution provision is intended to prevent circumvention of section 3(c)(1)'s 100 investor limit through the layering of intermediaries. Without this provision, an investment company could layer its investments in a number of section 3(c)(1) issuers to avoid regulation under the Act. Similarly, layered investments in section 3(c)(1) pools by other section 3(c)(1) issuers or proposed section 3(c)(7) issuers could undermine the policies supporting the issuer's exception from regulation under the Act. In the case of a section 3(c)(1) issuer, layering could create an excepted investment company structure with well over 100 investors; in the case of a section 3(c)(7) issuer, layering could result in an excepted structure composed of both sophisticated and less sophisticated investors.

The ICI has proposed that the attribution provision of section 3(c)(1) be expanded to reach issuers that are excepted from the definition of "investment company" under sections 3(c)(3), 3(c)(5), and 3(c)(11). Unlike issuers that are excepted under section 3(c)(1) and proposed section 3(c)(7), however, these issuers -- namely, banks, bank common trust funds, and savings and loan associations (section 3(c)(3)), industrial and mortgage finance subsidiaries (section 3(c)(5)), and pension and other employee benefit plans (section 3(c)(11)) -- are excepted from regulation under the Act for policy reasons unrelated to the number or financial sophistication of their investors. As such, these issuers would have no reason to layer their investments in section 3(c)(1) pools to avoid the Act. By way of example, pension plans that are excepted under section 3(c)(11) of the Act are subject to regulation under the Employee Retirement Income Security Act of 1974; separate regulatory oversight would continue to apply, and the exception would continue to be available, regardless of the plan's investment in any one or a number of section 3(c)(1) pools.

The Division is not aware of any investor protection concerns that would be implicated -- nor are we aware that any such concerns that have been raised -- as a result of the ability of issuers relying on sections 3(c)(3), 3(c)(5), and 3(c)(11) to invest in section 3(c)(1) pools. Indeed, prohibiting these excepted issuers from owning more than ten percent of a section 3(c)(1) pool would merely reintroduce unnecessary complexity in section 3(c)(1)'s attribution provision, creating a trap for the unwary. This would undermine the legislation's goal of facilitating capital participation in private investment companies. Accordingly, the Division believes that the Subcommittee should not adopt the ICI's proposed amendment to section 3(c)(1).

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[4] The attribution provision of section 3(c)(1) currently applies to *any* entity that (i) owns 10% or more of any one section 3(c)(1) issuer's voting securities and (ii) has invested more than 10% of its assets in section 3(c)(1) issuers.

I hope the Division's comments will be helpful in evaluating the ICI's proposed amendments to the Commission's small business initiatives. Please let us know if you have any questions or if we can provide any further assistance.

Sincerely,

Marianne K. Smythe
Director