WASHINGTON, DC • BRUSSELS • LONDON • WWW.ICI.ORG

# Comment Letter on Proposed Private Investment Company Rules, February 1997

**February 10, 1997**

Mr. Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street, N.W.
Stop 6-9
Washington, D. C. 20549

**Re: Private Investment Companies**
**(File No. S7-30-96)**

Dear Mr. Katz:

The Investment Company Institute[1] appreciates the opportunity to express its views on the Commission's proposal regarding rules under the Investment Company Act of 1940 to implement provisions of the National Securities Markets Improvement Act of 1996 (the "1996 Act") that apply to private investment companies.[2] The Institute appreciates the Commission's expeditious proposal of these rules, which are of great importance to the mutual fund industry, the investing public, and the American securities markets.

## I. Introduction and Background

Prior to enactment of the 1996 Act, the Investment Company Act exempted from its coverage any investment company with no more than one hundred investors that did not publicly offer its securities.[3] The 1996 Act added Section 3(c)(7) to the Investment Company Act to create a new exemption for any investment company that does not make a public offering of its securities and whose investors consist solely of financially sophisticated persons ("qualified purchaser pools").

The creation of an exemption from the Investment Company Act for pooled investment vehicles based on the presumed financial acumen of purchasers of the pool is completely unprecedented. Congress made it clear that the Commission should deem as qualified purchasers "only those persons . . . [that] may fend for themselves without the protection of the Investment Company Act"[4] and that investors in qualified purchaser pools should be able to "evaluate on their own behalf matters such as the level of a fund's management fees, governance provisions, transactions with affiliates, investment risk, leverage, and redemption rights."[5] Given this Congressional guidance and the potential dangers to the investing public and the markets from the sale of unregulated pools, the Commission should act cautiously in implementing this new and unprecedented exemption.

It is important to recognize that it was the existence of problematic practices involving investment pools, including insider dealings, improper valuation of securities, and excessive leveraging, that caused Congress to enact the Investment Company Act in the first place.[6] Recent history demonstrates that these dangers are ongoing hazards to investors in unregulated pooled investment vehicles.[7] Moreover, these dangers are not easily avoided, even by apparently "sophisticated" investors. The Institute has attached (as Appendix 1) a summary of recent scandals and losses involving unregulated pooled investment vehicles, most, if not all, of which arguably could have been avoided had such pools been in compliance with the Investment Company Act.[8] Some of the more noteworthy examples include the following:

Last year it was reported that a hedge fund, Theta, was being liquidated after alleged fraudulent transfers of investor funds and trading losses. The SEC has charged Theta's sponsors with materially misrepresenting Theta's risks, financial condition, and performance to investors. Investors in the fund lost much of their initial investment of $13.4 million in a little over a year.

The demise of the Orange County investment fund in 1995, reportedly due to overleveraging, portfolio illiquidity, and mispricing of assets, harmed many "sophisticated" investors, including more than 180 governmental bodies.

In 1995, David Askin, a hedge fund manager, settled SEC proceedings in which he was charged with fraudulent conduct in the collapse of his $600 million hedge fund. It was reported that the collapse caused serious harm to a host of "sophisticated" investors, including at least one large personal estate, a pension fund, major state universities, and large insurance and brokerage houses.

In light of these dangers, it is not surprising that the report of the Senate Banking Committee sought to make it clear that the Commission should make available the newly excepted qualified purchaser pools to only persons who can fend for themselves and evaluate on their own behalf matters that would otherwise be subject to the stringent investor protections of the Investment Company Act.[9] The Conference Committee further narrowed the scope of the exemption by eliminating the provision that would have vested the Commission with discretion to expand the definition of "qualified purchaser." [10] It would thus be contrary to Congressional intent and the interest of investors for the Commission to interpret Section 3(c)(7) in a manner that would allow a broad class of investors to invest in qualified purchaser pools.[11]

Moreover, in considering rules that will refine the scope of the exception under Section 3(c)(7), the Commission should bear in mind that exemptions may, and often do, over time, exceed their intended scope. A prime example of this is Section 3(c)(11) of the Investment Company Act, which was intended to exempt defined benefit retirement plans sponsored by large corporations (and certain of their funding vehicles). As the SEC staff itself noted in its 1992 study of investment company regulation, despite the intended scope of the exemption, it now also is used by defined contribution retirement plans (and certain of their funding vehicles), including those, such as Section 401(k) plans, in which individual employees are responsible for investment decisions.[12] As a result, millions of investors have been deprived of the protections of the federal securities laws, even though there is no indication that Congress intended such a result. This underscores the need for the Commission to use its rulemaking authority to define terms under new section 3(c)(7) narrowly and precisely.

The Institute's specific comments on the proposal are based upon the foregoing policy considerations. In particular, we strongly encourage the Commission to address two matters that are not discussed in detail in the proposing release -- the statutory prohibition on public offerings and the statutory limitation on investments in Section 3(c)(7) pools to qualified purchasers. The Institute also has several comments on the proposed definition of "investments," which is overly broad in some respects but generally in keeping with Congressional intent. Finally, the Institute has comments on other aspects of the proposal, including the proposed "safe harbor" under the non-integration provision.

Each of these matters is discussed below.

## II. Meaning of the No Public Offering Requirement

New Section 3(c)(7) requires any pooled investment vehicle that wishes to rely on the qualified purchaser pool exception not to make or propose to make a "public offering" of its securities.[13] While the Commission recites this requirement in a footnote to the Release,[14] the meaning of that requirement is not explained.

This statutory requirement is extremely important because it helps to assure that unsophisticated individuals will not be inadvertently drawn into qualified purchaser pools and because it serves to prevent the public from confusing unregulated qualified purchaser pools with mutual funds and other SEC-regulated investment companies.[15]

To help to assure compliance with the no public offering requirement, the Institute recommends that the Commission make clear in the adopting release that whether a particular pool satisfies the requirement will depend on the facts and circumstances of the offering, but the Commission intends the requirement generally to mean that the pool or any person acting on its behalf will not offer or sell interests in the pool by any form of general solicitation or general advertising, including, but not limited to (1) any advertisement, notice, or other communication published in any newspaper, magazine, or similar media or broadcast over television, radio, or computer; or (2) any seminar or meeting whose attendees have been invited by any general solicitation or general advertising.[16] We believe that such a statement by the Commission is critical, especially in light of the widespread availability and use of the Internet, which provides a significant means for providing information to the general public about totally unregulated pools.[17]

## III. Limiting Investments to Qualified Purchasers

The Institute recommends that, consistent with the language of Section 3(c)(7)(A) and the legislative history of the 1996 Act, the Commission prominently state in the adopting release that each purchaser of an interest in a qualified purchaser pool must itself be a qualified purchaser.[18] Consistent with this principle, the Institute recommends that the Commission make clear in the final rule that participant directed retirement plans would not be permitted to invest in any qualified purchaser pool unless all plan participants are themselves qualified purchasers.[19]

In addition to being inconsistent with the plain language and clear intent of the legislation, it would be unwise public policy if the Commission permitted participant directed retirement plans consisting of nonqualified purchasers to invest in the exempt pools. As the Commission staff previously has observed, these pension plans place the responsibility on employee-participants to choose their own investments and bear the associated investment risk.[20] Therefore, it would be inappropriate for the Commission to permit employees who lack the requisite financial sophistication to invest indirectly in the qualified purchaser pools through their pension plans.[21]

Conversely, in determining if any non-contributory retirement plan that is not participant directed (or any of its funding vehicles) is a qualified purchaser, we believe it is appropriate to measure the aggregate investments of all such retirement plans of the employer and any employer-owned investments to determine if the plans and the funding vehicles are qualified purchasers.[22] Relying on the status of the employer as a qualified purchaser is appropriate in these circumstances because the employer bears responsibility for making the investments and bears any associated investment risk. In addition, this recommendation is consistent with Section 2(a)(51)(A)(iii) of the Investment Company Act, which provides that a trust is a qualified purchaser if, among other requirements, the "person who has contributed assets to the trust" is a qualified purchaser.

# IV. Definition of Investments

## A. Congressional Guidance

In creating the new exemption for qualified purchaser pools, Congress charged the Commission with defining the term "investments." Because persons with a specified amount of investments are deemed to be qualified purchasers, the Commission's definition of this term is of critical importance in implementing the new exemption as Congress directed.

As noted above, the legislative history of Section 3(c)(7) makes it clear that Congress intended the Commission to limit the scope of "qualified purchasers" to those persons that can "fend for themselves" and "evaluate on their own behalf " unregulated investment pools.[23]

The Institute believes that the Commission's proposed definition of investments is generally consistent with Congressional intent. The Commission proposes to include most securities as investments.[24] The Commission also proposes to designate as investments certain assets that are "held for investment purposes" and that are indicative of experience in the financial markets or investing in unregulated investment pools such as commodity interests. Conversely, and also in accord with Congressional intent, the Commission does not propose to include every possible kind of an asset as an investment. For example, the proposed rule would not define as "investments" art, jewelry, antiques, and other collectibles. In certain respects, however, we believe that the Commission's proposal may be too expansive, in that it would include as investments assets that do not indicate financial sophistication. This view is explained in more detail below.

## B. Assets Qualifying as Investments

As an initial matter, the Institute supports the approach of specifying certain assets as qualifying as "investments," rather than specifying certain assets that do not qualify. This approach establishes an appropriately bright line regarding which assets will qualify as "investments" and assures that the Commission will retain control over which assets qualify as investments, consistent with Congressional intent.[25]

With respect to the specific assets that would be considered "investments" under the proposal, the Institute supports the proposed exclusion of art, jewelry, antiques, and other collectibles that may be held by some persons as investments. These assets are not indicative of the financial sophistication that Congress deemed as a necessary prerequisite to investing in a qualified purchaser pool.[26] In contrast, ownership of assets such as certain commodity interests held for investment purposes and securities (other than securities of an issuer that controls, is controlled by, or is under common control with the person that owns such securities)[27] do appear relevant in ascertaining whether a person may be in a position to appreciate the risks associated with investing in an unregulated investment pool.

Several other types of assets that would be considered investments under the Commission's proposal, however, would not appear to provide assurance of investors' ability "to fend for themselves" and "evaluate on their own" the attributes of a qualified purchaser pool.[28] Specifically, the Institute strongly opposes the inclusion of : (1) all "cash and cash equivalents held for investment purposes;"[29] (2) "all real estate held for investment purposes;"[30] and (3) physical commodities held for investment purposes (e.g., gold and silver).

In addition, in response to the Commission's specific request for comment, we would object to the Commission including as investments "other property that produces income from interest, dividends, annuities or royalties not derived in the ordinary course of business." This terminology is open-ended and vague and, therefore, would deprive the Commission of control over which assets qualify as investments. Further, in response to the Commission's specific request for comment, the Institute would object to counting as investments controlling interests in large privately held businesses and any passive ownership interest in a business. These ownership interests may reflect familiarity and expertise with running a particular business, but are not relevant to one's ability to evaluate investment in unregulated investment pools. In addition, inclusion of these interests as investments would be inconsistent with Congressional intent.[31]

### C. Value of Investments

The Institute strongly supports excluding the amount of any outstanding indebtedness incurred to acquire investments in valuing a prospective purchaser's investments. While this approach may place administrative burdens on qualified purchaser pools, we believe that Congress intended that qualified purchasers be limited to persons who own a specified amount of investments.[32] It would be inconsistent with Congressional intent to permit a prospective qualified purchaser to accumulate the requisite amount of investments through borrowings. Similarly, it would be inconsistent with this intent to only deduct from the value of investments loans secured by investments. Rather, the Institute recommends that the Commission deem any indebtedness collateralized by an investment (whether directly or indirectly) as having been incurred to acquire the investment (and therefore excluded from the value of investments) as well as excluding other indebtedness incurred to acquire investments. This approach is necessary to assure the deduction of any indebtedness incurred that would indirectly permit the acquisition of an investment.[33]

In addition, the Institute strongly supports requiring any loan to a natural person secured by a mortgage on the person's personal residence or other real estate to be deducted unless the loan proceeds were used solely to finance the acquisition or improvement of the property. Without this requirement, a person would be permitted to convert a personal residence into an investment, a result that clearly would be inconsistent with Congress's intent in enacting the qualified purchaser provision.[34]

The Institute also supports requiring natural persons[35] and family companies to deduct from the amount of their investments certain amounts received during the preceding 12 months (including payments received pursuant to an insurance policy, the value of any investments received by the person as a gift or bequest or pursuant to an agreement related to a legal separation or divorce, and any amount received by the person in connection with a lawsuit). Since these payments do not reflect investment experience, they should be excluded from the calculation of a person's investments.

### D. Good Faith Reliance on Certain Documentation

It is important for a person acting on behalf of a qualified purchaser pool to have a reasonable basis for believing that a prospective purchaser qualifies to purchase an interest in the pool. For this reason, the Institute generally supports the proposed approach of requiring a purchaser to provide documentation regarding its ownership of investments and requiring that the reliance on such information be reasonable and that, after reasonable inquiry, the qualified purchaser pool's representatives not have any basis for believing that the information is incorrect in any material respect. In addition, it is important to require representatives of qualified purchaser pools to make these inquiries because it is likely that these pools will be marketed to persons that are marginally qualified. A reasonable inquiry standard is necessary to help protect against the pools being made available to persons that are not truly qualified.[36]

Because there may be a variety of ways for this obligation to be satisfied, the Institute does not believe that it is necessary for the Commission to set forth an exclusive list of documentation required or a non-exclusive list such as that provided by Rule 144A.[37] The Institute recommends, however, that the Commission provide guidance regarding the meaning

of the rule's requirement that documentation be "as of a recent date" (e.g., information must be as of a date within 16 months preceding the date of the sale of the interest in the qualified purchaser pool).[38] This would provide persons relying on the rule with more certainty regarding their obligations.

### E. Qualification Requirement

The Institute strongly supports the requirement that an investor must meet the definition of qualified purchaser both at the time that it initially purchases an interest in the pool and at any time it adds to its investment in the pool.[39] While satisfying this requirement will require establishment of administrative procedures and may cause the disqualification of certain investors,[40] in light of the plain language of Section 3(c)(7)(A), we do not believe that the Commission has the flexibility to relax this requirement.[41] In addition, requiring investors to meet the statutory standards regarding financial resources on an on-going, not a fleeting, basis is sound policy.

## V. Other Issues

### A. Conforming Rule

The Institute strongly supports proposed Rule 2a51-3 which would make clear that a company can not be formed for the specific purpose of acquiring interests in a qualified purchaser pool unless each beneficial owner of the company's securities or other interest in the company is a qualified purchaser. Such a rule is necessary to make clear to persons relying on the new exemption that one may not do indirectly what is directly prohibited.[42]

## B. Nonexclusive Safe Harbor for Certain Section 3(c)(7) Funds

The Institute opposes the proposed non-exclusive safe harbor from integration for sponsors of any grandfathered 3(c)(1) pool who convert it to a 3(c)(7) pool ("grandfathered fund") and who form a new 3(c)(1) pool if 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 intent of the non-integration provision was limited to the situation in which a sponsor of an existing 3(c)(1) fund wishes to start a new 3(c)(7) pool with similar investment objectives without fear of integration of the two pools. The grandfather provision was intended to allow a sponsor of an existing 3(c)(1) fund to convert that fund into a 3(c)(7) fund to permit existing investors to participate in the newly-converted fund.[43] In short, sponsors of 3(c)(1) funds were provided with two distinct avenues for establishing Section 3(c)(7) funds.

Further, there is no adequate policy justification to provide a non-integration safe harbor for "converted" Section 3(c)(7) funds and new Section 3(c)(1) funds. As the Commission's release notes, a possible danger of allowing a sponsor to convert a Section 3(c)(1) fund into a Section 3(c)(7) fund in order to create another Section 3(c)(1) fund may be to indirectly permit circumvention of the 100 investor limit of Section 3(c)(1), even though Congress expressly declined to amend Section 3(c)(1) to increase that limit.[44] Consequently, the Institute strongly recommends that the Commission, rather than adopting the proposed safe harbor, make clear that the non-integration provision is only applicable to Section 3(c)(1) funds that were in existence on October 11, 1996.[45]

## C. Knowledgeable Employees

The Institute believes that the aspect of the definition of "knowledgeable employee"[46] that includes employees who, in connection with their regular duties "obtained information" regarding the investment activities of the fund is too broad because it could include employees such as compliance personnel who are not necessarily knowledgeable about the risks of investing. Such a broad definition would be inconsistent with the 1996 Act's apparent intent to permit, through Commission rule, investments in private funds by natural persons who actively participate in the management of the fund's investments.[47] The Institute otherwise supports the proposed treatment of knowledgeable employees.

## D. Transition Rule for Section 3(c)(1) Funds

The Institute supports proposed Rule 3c-1 which would provide that the amended look-through provision of Section 3(c)(1) does 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 October 11, 1996, provided that the investor continues to satisfy the second 10% test. The proposed rule appropriately would preserve the exempt status of certain private investment companies in a way that does not appear to be inconsistent with the legislation.[48]

* * *

The Institute appreciates the opportunity to comment on this highly significant proposal, which will be of enormous consequence to the investing public, the continued success of the regulatory scheme established by the Investment Company Act, and the securities markets in general. The Institute has consistently supported the creation of a new exemption for qualified purchaser pools provided its parameters were narrowly drawn by Congress. Congress has done so and has indicated that the Commission deem as qualified purchasers "only those persons that may fend for themselves without the protection of the Investment Company Act. . ."[49] and that investors in qualified purchaser pools should be able to "evaluate on their own behalf matters such as the level of the fund's management fees, governance provisions, transactions with affiliates, investment risk, leverage, and redemption rights"[50] in administering the new exemption. The exercise of caution by the Commission is appropriate given this Congressional guidance and in light of the history of unregulated pools both before enactment of the Investment Company Act and in recent years. Our comments are intended to help the Commission fulfill its Congressional mandate. If you have any questions regarding the matters discussed herein, please contact the undersigned at 202/326-5810.

Very truly yours,

Paul Schott Stevens
Senior Vice President and General Counsel

cc: Chairman Arthur Levitt
Commissioner Steven M. H. Wallman
Commissioner Isaac C. Hunt
Commissioner Norman S. Johnson
Barry P. Barbash, Director, Division of Investment Management
Robert E. Plaze, Associate Director, Division of Investment Management
Kenneth J. Berman, Assistant Director, Division of Investment Management

Nadya B. Roytblat, Assistant Chief, Division of Investment Management
David P. Mathews, Senior Counsel, Division of Investment Management

**ENDNOTES**

1

[1] The Investment Company Institute is the national association of the American investment company industry. Its membership includes 6,170 open-end investment companies ("mutual funds"), 443 closed-end investment companies, and 10 sponsors of unit investment trusts. Its mutual fund members have assets of about $3.49 trillion, accounting for approximately 95% of total industry assets, and have over 59 million individual shareholders.

[2] Investment Company Act Release No. 22405, International Series Release No. 1037 (Dec. 18, 1996) ("Release").

[3] Section 3(c)(1) of the Investment Company Act.

[4] S. Rep. No. 293, 104th Cong., 2d Sess. 10 (1996) (emphasis added).

[5] Id.

[6] See, e.g., Section 1(b) of the Investment Company Act.

[7] As explained in recent testimony, many practices currently engaged in by unregulated pooled investment vehicles are deemed impermissible for registered investment companies. These include significant financial involvement by a fund manager in the portfolio companies in which the fund invests, long "lock-up" periods for invested capital, during which time withdrawal or redemption is prohibited or very circumscribed, and investments in companies for which mark-to-market valuation is not feasible. See, e.g., Testimony Concerning H.R. 1495, the "Investment Company Act Amendments of 1995," and its Effect on Private Investment Partnerships before the Subcomm. on Telecommunications and Finance, Comm. on Commerce, 104th Cong., 1st Sess. (1995) (statement of Marianne K. Smythe, Partner, Wilmer, Cutler & Pickering) ("Smythe Testimony") 7-8.

[8] Some of these pooled investment vehicles were relying on exemptions from the Investment Company Act and thus were not required to register under that Act. See Conference Report on H.R. 3005, National Securities Market Improvement Act of 1996 (statement of Congressman John D. Dingell) (Oct. 21, 1996) ("Dingell Statement") (noting Congress's appreciation of the potential dangers to the investing public from investing in unregulated investment pools and reciting several recent examples of failed investment funds).

[9] S. Rep. at 10.

[10] See Dingell Statement ("for investor protection reasons, the conferees rejected the Senate amendment's provisions that would have allowed the SEC by rule to specify additional qualified purchasers who did not meet the statutorily defined standards of financial sophistication . . . . Given this record and the purposes of the Investment Company Act, it is not the intention of Congress that the SEC would use its authority under section 6(c) of the Act to reduce the thresholds or to ease the statutorily-established conditions to this exemption.")

[11] A more detailed analysis of the 1996 Act's legislative history is included infra at pps. 6-7.

[12] See Protecting Investors: A Half Century of Investment Company Regulation (May 1992) at 119-120, 151 ("[w]hen the securities laws exceptions for pooled investment vehicles were enacted, pension plans were predominantly 'defined benefit' plans . . . [d]uring the last two decades, many employers . . . have offered their employees 'defined contribution plans'. . . we recommend . . . legislation that would remove the current exemption . . . for interests in pooled investment vehicles consisting of assets of participant-directed defined contribution plans . . . [t]he historical reasons justifying the securities laws exemptions of pooled vehicles for employee benefit plan assets -- that "sales" are made to sophisticated employers and that the employers bear the risk of loss -- are both inapposite in the case of participant-directed defined contribution plans. . . " ) The staff specifically recommended legislation: to require registration under the Securities Act of interests in certain pooled investment vehicles that fund participant-directed defined contribution plans; to require the delivery of prospectuses for the pooled investment vehicles to plan participants who direct their investments; and to require the delivery of semiannual and annual shareholder reports for the pooled investment vehicles to these plan participants. The staff did not recommend that these pooled investment vehicles be required to register under the Investment Company Act.

[13] Section 3(c)(7)(A).

[14] Release at note 4.

[15] The danger of such confusion is not speculative. Recent articles in the financial press have blurred the distinction between exempt pooled investment vehicles and SEC-regulated investment companies. Articles reporting the derivative losses experienced by Atlantic Richfield's exempt funding vehicle for its retirement plan provide one such example. See, e.g.,"Derivatives Are Blamed in ARCO Fund's $22 Million Loss" Los Angeles Times (May 14, 1994) ("Employees ... expressed varying degrees of shock and disappointment with the performance of the Arco-managed Money Market Plus Fund... Arco said it has liquidated all of the derivative securities in question and changed the investment strategy of the money market fund to avoid such investments in the future....Typically, money market funds invest in commercial paper, government securities, certificates of deposit and other usually liquid and relatively safe securities."); "Savings Plan Loses $22 Million on Derivatives" Washington Post (May 16, 1994) ("[t]he loss came in a company-managed money market fund that has routinely used interest rate derivatives to boost investment yields. . . . Money market funds usually are thought of as low-risk investments."); "Derivative Losses Beginning to Hit Some Benefit Plans" Business Insurance (May 23, 1994) ("I have never before seen derivatives used in anything called money market or stable value fund . . .. ARCO's big mistake was them calling this a Money Market Plus Fund; all of us think you're never supposed to lose money in a money market fund" (quoting a retirement consultant).) See also "Orange County, Calif. Says Investment Pool Took $1.5 Billion Hit" Bond Buyer (Dec. 2, 1994) ("the basic synopsis of the problem is that rapidly rising interest rates have affected bond funds nationwide, including the Orange County investment fund").

[16] As part of the discussion, the Commission should make clear that Section 3(c)(7)'s no public offering requirement is no different than that requirement in other contexts under the federal securities laws. See, e.g. Rule 502(c) under the Securities Act of 1933 and IPONET (pub. avail. July 26, 1996).

[17] See e.g., Van Hedge Fund Advisors Website at www.nashville.net. Van Hedge Fund Advisors states that, based on its research and published surveys, its database is the largest actively tracked hedge fund database in the world. See also "Hedge Fund Consultants Need Scrutiny Too: Minding Money" Bloomberg Business News Personal Columns Minding Money (Dec. 26, 1996) ("In each of the last two years, Van . . . placed his clients in a fund that later ran into serious trouble with the Securities and Exchange Commission."). (Copy attached as Appendix 2.)

[18] See S. Rep. at 10 ("[o]nly qualified purchasers may purchase interests in a qualified purchaser pool for their own account or the account of other qualified purchasers. An investment adviser managing private accounts would not be permitted to purchase interests in a qualified purchaser pool on behalf of a client unless that client is also a qualified purchaser."); and H. Rep at 52-53 (" [a]n institutional investor purchaser, however, could invest in a Section 3(c)(7) fund only for its own account or for the accounts of other qualified purchasers."). In light of the statute and the quoted legislative history, it clearly would be inconsistent with Congressional intent for the Commission to permit investment in a qualified purchaser pool by a person with less than $5 million in investments even if that person had access to a financial adviser (e.g., a person with $5 million in assets, not investments).

The Commission could note that the only exceptions to this general rule would be the specific exceptions statutorily provided in Section 3(c)(7)(A) and (B).

[19] For example, a participant directed defined contribution plan with $25 million in investments would not be eligible to invest in a qualified purchaser pool unless all plan participants themselves owned $5 million or more in investments or were knowledgeable employees of the issuer. In determining whether a participant has the requisite $5 million in investments, presumably that participant could count the value of investments owned in its participant directed retirement plan. Appendix 3 provides recommended rule text to implement this recommendation.

[20] See Protecting Investors at 150.

[21] Recent Institute research found that the median household income of shareholders with 401(k) plans is $60,000 and their median household financial assets outside of employer-sponsored retirement plans are $30,000. See Investment Company Institute, Fundamentals, "Shareholders with 401(k) Plans Invested in Mutual Funds" (May/June 1996). This is clearly far below the statutorily established standards for qualified purchasers.

[22] We understand that employers sometimes establish multiple trusts as funding vehicles for their non-contributory retirement plans that are not participant directed to facilitate plan administration or, occasionally, to facilitate investment management by distinct investment managers and to limit the potential liability associated with the investments of any particular trust.

[23] S. Rep. at 10 (emphasis added). These statements in the Senate Report are consistent with earlier statements made by the Commission and its staff. See, e.g., Testimony Concerning H.R. 1495, the Investment Company Act Amendments of 1995 before the Subcomm. on Telecommunications and Finance of the Comm. on Commerce, 104th Cong., 1st Sess. (1995) (statement of Barry P. Barbash, Director, Division of Investment Management, U.S. Securities and Exchange Commission) 27-29 ("[t]he qualified purchaser alternative would recognize that financially sophisticated investors are in a position to appreciate the risks associated with investment pools that do not have the Investment Company Act's protections.") and Protecting Investors at 110 ("an exception for funds owned

by sophisticated investors would be premised on the theory that such investors can adequately safeguard their interests in a pooled investment vehicle without extensive federal regulation.")

[24] The House bills that preceded the legislation ultimately passed by Congress (H.R. 1495, the "Investment Company Act Amendments of 1995" and H.R. 3005, the "Securities Amendments of 1996") would have deemed as qualified purchasers natural persons with $10 million in securities of certain unaffiliated issuers and institutions with $100 million in securities of certain unaffiliated issuers. Subsequently, the Senate bill (S. 1815) would have deemed as qualified purchasers persons who held a certain amount of "investments" instead of securities. The Senate bill was viewed as an expansion of the earlier House action. See, e.g., Testimony Concerning S. 1815, the "Securities Investment Promotion Act of 1996" before the Comm. on Banking, Housing, and Urban Affairs, 104th Cong., 2d Sess. (statement of Arthur Levitt, Chairman, U.S. Securities and Exchange Commission) (1996) 10.

[25] See supra at note 4.

[26] Predictably, the Commission will receive numerous comments from potential sponsors of qualified purchaser pools urging the Commission to define investments more broadly -- not necessarily in terms that address the financial sophistication of the investor, but instead in terms of the potential size of the market for this new product. See, e.g., Testimony before the Comm. on Banking, 104th Cong., 2d Sess. (1996) (statement of Christopher Brody, partner, Warburg, Pincus and Co. on behalf of the National Venture Capital Association) 12 ("the crucial question . . . is whether the definition of qualified purchasers in the proposed legislation is overly narrow. I want to emphasize this point: an overly-narrow definition of "qualified purchaser" will not . . . increase [our] . . . access . . . to capital . . ..")

[27] The Institute supports including in the definition of investments securities issued by investment companies and listed companies that are not majority-owned subsidiaries of the person that owns the securities (or a person that controls, is controlled by, or under common control with such person) despite the existence of a control relationship between the purchaser and the company.

[28] See S. Rep. at 10 (emphasis added); see also Release at 13 (the nature of the asset should indicate a significant degree of investment experience and sophistication such that the investor can be expected to have the knowledge to evaluate the risks of investing in unregulated investment pools.)

[29] The Institute recommends instead that the Commission include as an investment cash or cash equivalents that represent proceeds from the sale of investments within the last six months (or another recent period). The recommended approach would recognize that investors in securities and commodity interests may have a component of their investment portfolio in cash at any given time and would treat this cash as an investment. It would not, however, broadly treat as investments assets such as certificates of deposit that typically do not reflect sophistication regarding the financial markets. Under the Commission's proposal, a person with $5 million in certificates of deposit would be considered a qualified purchaser. We do not believe that Congress intended such a result.

[30] The Institute recommends that the Commission instead only include interests in real estate that are held in the form of a security.

[31] See S. Rep. at 10 ("[t]he Committee does not anticipate or recommend the inclusion, for example, of a controlling interest in a privately owned family business . . ..") We further recommend that the proceeds from the sale of such interests be excluded for a reasonable period of time. This would be consistent with the Commission's proposed treatment of payments pursuant to, among other things, an insurance policy.

[32] See Section 2(a)(51)(A) ("any natural person. . .who owns not less than $5,000,000 in investments. . . .") (emphasis added). We also support the Commission's proposal not to require such a deduction with respect to investments that a person manages on a discretionary basis for others because the statute permits the measurement of any assets invested on a discretionary basis. In addition, such a requirement would be difficult to administer, adding cost to the advisory business without any offsetting benefits.

[33] The Institute similarly supports the proposed deductions required to be made by family companies in proposed Rule 2a51-(g)(3) and (4) and the proposed valuation of commodity interests.

[34] See S. Rep. at 10 (where it was stated that the Committee did not expect the Commission to define investments to include a personal residence.)

[35] The Institute notes that by including in the value of investments any investments held jointly with such person's spouse, the Commission effectively would be permitting these assets to be counted twice, once by each spouse, to determine if any given spouse is a qualified purchaser. The Institute questions the need for such flexibility especially in light of the statutory provision permitting a nonqualified purchaser to hold a joint interest in a qualified purchaser pool with a qualified purchaser spouse.

[36] After an initial determination has been made that a person is a qualified purchaser, qualified purchaser pools may be able to

satisfy the rule's proposed reasonable belief and inquiry standards for subsequent purchases by that person by ascertaining changes in a person's finances subsequent to the initial determination (rather than asking for and reviewing the information that was initially provided.)

[37] For example, it does not appear to be appropriate to require natural persons to provide audited financial statements. Extremely few individuals have audited financial statements and because auditing standards focus on businesses rather than individuals, audit reports typically are not readily available. The Institute recommends that the Commission make clear that reliance on an individual's unaudited financial statements generally would be permitted under the final rules.

[38] See Rule 144A(d).

[39] See, e.g., Release at note 55.

[40] It may be appropriate to make clear that qualified purchaser pools are not required to make this determination prior to reinvesting earnings on behalf of an investor. This would be consistent with the treatment of shares issued in connection with dividend reinvestment plans under the federal securities laws. See, e.g., Investment Company Act Rel. No. 20874 (February 1, 1995) at 6 (shares issued in connection with dividend reinvestment plans generally are not treated as sales of stock for purposes of registration requirements under the Securities Act of 1933).

[41] Section 3(c)(7)(A) provides that the outstanding securities of a qualified purchaser pool must be owned "exclusively by persons who, at the time of acquisition of such securities, are qualified purchasers" (emphasis added).

[42] This proposed rule is consistent with the Institute's recommendation regarding participant directed retirement plans. We would object to the Commission permitting pools that are formed for the specific purpose of investing in a qualified purchaser pool to so invest even if limits were placed on the extent to which that pool would invest in a qualified purchaser pool (e.g., no more than 40% of the pool's assets would be invested in a qualified purchaser pool). The Commission staff has considered such a limit to be relevant in determining whether a private investment company is facilitating individual decisionmaking in a way that would require that the staff "look through" and count the underlying shareholders of a partnership for purposes of the 100 investor limit in Section 3(c)(1). See, e.g., Cornish & Carey Commercial, Inc. (pub. avail. June 21, 1996). Such a limitation has no relevance, however, in determining if participants in such a pool are qualified purchasers.

[43] See Smythe Testimony at 11-16 and 17-18 (containing two distinct recommendations -- one for a safe harbor from integration to assure sponsors of existing 3(c)(1) funds that they are permitted to organize new 3(c)(7) funds without the risk of integration with existing 3(c)(1) funds and a second for a grandfather clause to permit orderly conversion of funds that presently rely on section 3(c)(1) into 3(c)(7) funds.). See also American Bar Association, Section of Business Law, Committee on Federal Regulation of Securities, Task Force on Hedge Funds, Report on Section 3(c)(1) of the Investment Company Act of 1940 and Proposals to Create an Exception for Qualified Purchasers, 51 Bus. Law. 773, 790-791 (Dec. 5, 1995).

[44] Release at 39.

[45] If the Commission is unwilling to do so, new rule 3c-7 should require that 50% or more of the value of all securities of the grandfathered fund be held by qualified purchasers that acquired these securities after October 11, 1996. Fifty percent would seem to be a bare minimum for establishing whether an existing Section 3(c)(1) fund's investors have changed sufficiently so that the Section 3(c)(1) fund may be treated as a Section 3(c)(7) fund for purposes of the non-integration provision. In addition, the Institute does not believe that existing investors that are qualified purchasers on the date that the grandfathered fund avails itself of Section 3(c)(7) should be counted for purposes of the proposed threshold. If the purpose of requiring that interests in the grandfathered fund be held by a certain percentage of new qualified purchasers is to distinguish the grandfathered fund from the new Section 3(c)(1) fund, it is critical that interests in the grandfathered fund be held by a significant percentage of new qualified purchasers.

[46] Such knowledgeable employees of a Section 3(c)(1) fund would be permitted to invest in a Section 3(c)(1) fund without regard to the 100 investor limit and such knowledgeable employees of a Section 3(c)(7) fund would be permitted to invest in a Section 3(c)(7) fund even though they did not meet the definition of qualified purchaser.

[47] Release at 43.

[48] Release at 41.

[49] S. Rep. at 10 (emphasis added).

[50] Id.