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## Chapter 2

# Private Investment Company Exceptions

### I. Introduction and Summary

The Investment Company Act,<sup>2</sup> under section 3(c)(1),<sup>3</sup> excepts from the definition of investment company "[a]ny issuer whose outstanding securities (other than short-term paper) are beneficially owned by not more than one hundred persons and which is not making and does not presently propose to make a public offering of its securities." The exception, often referred to as the "private investment company" exception, is used by a wide variety of issuers that provide important sources of capital to small businesses and others. At one end of the financial spectrum, small groups of investors known as investment clubs rely on it because registering and complying with the Act would be too costly. At the other end, well-capitalized investment pools with sophisticated investors rely on the exception to avoid substantive regulation under the Act. These pools include venture capital funds, acquisition vehicles, subsidiaries of large corporations formed to manage excess cash, leveraged buyout funds, hedge funds, and certain structured financings.

To rely on section 3(c)(1), an issuer must meet both elements of the exception. It may not have more than 100 holders of its debt and equity securities, other than purchasers of its commercial paper, *and* it may not be making or presently proposing to make a public offering. While the public offering prohibition is relatively straightforward: the 100 investor limit is complicated by a two-part attribution provision intended to prevent circumvention of the limit through layers of intermediaries. Section 3(c)(1)'s

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<sup>2</sup>On March 11, 1992, the Commission approved the Division's recommendations discussed in this chapter to amend section 3(c)(1) of the Investment Company Act and to create a new exception from the Act for issuers whose securities are held exclusively by qualified purchasers. These proposals were introduced in Congress as part of the Small Business Incentive Act of 1992. S. 2518, 102d Cong., 2d Sess. (Apr. 2, 1992); **H.R.** 4938, 102d Cong., 2d Sess. (Apr. 9, 1992). See *Hearings on the Small Business Incentive Act of 1992*, 102d Cong., 2d Sess. (Mar. 26, 1992).

\*Investment Company Act of 1940, 15 U.S.C. § 80a.

<sup>3</sup>15 U.S.C. § 80a-3(c)(1).

<sup>4</sup>An offering that qualifies as a non-public offering under section 4(2) of the Securities Act of 1933 (15 U.S.C. § 77d(2)) and rule 506 of Regulation D (17 C.F.R. § 230.506) also generally qualifies as non-public for purposes of section 3(c)(1). *Santa Barbara Securities* (pub. avail. April 8, 1983).

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attribution provision also determines **which** section 3(c)(1) issuers are deemed to be investment companies for purposes of the "fund of funds" investment restrictions of section 12(d)(1) of the Act?

Companies relying on section 3(c)(1) also must take care to avoid "integration" with related issuers.<sup>6</sup> If other issuers are integrated with the private investment company, their security holders will be aggregated with the security holders of the private investment company for purposes of determining compliance with the 100 investor limit?

The private investment company exception has fostered the development of investment vehicles well-suited for sophisticated investors<sup>8</sup> Often, however, large-scale capital participation by sophisticated investors in private investment companies is frustrated by the requirements of section 3(c)(1). For issuers whose securities are owned exclusively by sophisticated investors, the public offering prohibition and 100 investor limit are unnecessary constraints not supported by sufficient public policy concerns. Therefore, the Division recommends an amendment to the Investment Company Act to create a new exception for funds whose securities are held exclusively by "qualified purchasers" as defined by rule. The new exception would be premised on the theory that "qualified purchasers" do not need the Act's protections because they are able to monitor such matters

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<sup>5</sup>15 U.S.C. § 80a-12(d)(1). The attribution provision of section 3(c)(1) and its role in determining which issuers are subject to the restrictions of section 12(d)(1) are described *infra* notes 13-16 and accompanying text.

<sup>6</sup>The integration concept allows the Commission to look behind ostensibly separate issues, issuers, or transactions to determine if, in economic reality, they are actually a single issue, issuer, or transaction. *See generally* Interpretive Release Relating to the Securities Act and General Rules and Regulations Thereunder, Securities Act Release No. 4552, 1 Fed. Sec. L. Rep. (CCH) ¶ 2770 at 2918 (Nov. 6, 1962) (articulating five factors relevant to the question of integration under the Securities Act).

<sup>7</sup>*See, e.g.*, Meadow Lane Associates, L.P. (pub. avail. May 24, 1989); Frontier Capital Management Company, Inc. (pub. avail. July 13, 1988); PBT Covered Option Fund (pub. avail. Feb. 17, 1979). For a discussion of the integration issue and other questions that arise under section 3(c)(1), see Thomas P. **Lemke** & Gerald T. **Lins**, *Private Investment Companies Under Section 3(c)(1) of the Investment Company Act of 1940*, 44 **BUS. LAW.** 401, 424-28 (1989).

<sup>8</sup>This appears to be a relatively recent development. In 1940, institutional participation in pooled investment vehicles was relatively minor. Since that time, institutional investors have become active participants. At the end of 1990, they accounted for approximately 34% of total mutual fund assets. INVESTMENT COMPANY INSTITUTE, 1991 MUTUAL FUND FACT **BOOK: INDUSTRY TRENDS AND STATISTICS FOR 1990**, at 53 (1991).

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as management fees, transactions with affiliates, corporate governance, and leverage.

The Division also recommends legislation to amend section 3(c)(1). The current structure of section 3(c)(1) is overly complicated and unnecessarily restricts investments by both corporate investors and registered investment companies. Reform of section 3(c)(1) would encourage participation in private investment companies without lessening investor protection?

Finally, the Division believes that the inter-fund, or "fund of funds," investment restrictions of section 12(d)(1) as applied to private issuers should be revised. Specifically, section 3(c)(1) should be amended to eliminate section 12(d)(1)'s limits on investments by registered investment companies in private investment companies. In order to protect the public shareholders of registered investment companies, however, the restrictions of section 12(d)(1) should apply to all investments by private issuers in registered investment companies. This approach also should be incorporated in the proposed "qualified purchaser" exception.

Section 11 of this chapter discusses the private investment company exception in section 3(c)(1) and our recommendations to modify the attribution provision and the "fund of funds" restrictions in that exception. Section 11I discusses our recommendation to create a new exception under the Investment Company Act for funds whose securities are held exclusively by "qualified purchasers." Section IV briefly describes other options that we considered.

## 11. The Private Investment Company Exception

Section 3(c)(1) reflects Congress's belief that federal regulation of private investment companies is not warranted. The 100 investor limit and public offering prohibition are both designed to ensure the private nature of exempted issuers.<sup>10</sup> When there is no public offering, the 100 investor limit, while

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<sup>9</sup>In connection with this change, the Division recommends a related amendment to section 3(a)(3) to prevent companies from avoiding regulation under the Act through investment in subsidiaries that qualify as section 3(c)(1) issuers. See *infra* note 18 and accompanying text. The Division recommends that the amendment to section 3(a)(3) also cover issuers relying on the new "qualified purchaser" exception.

<sup>10</sup>See SMALL BUSINESS INVESTMENT INCENTIVE ACT OF 1980, H.R. REP. NO. 1341, 96th Cong., 2d Sess. 34-35 (1980) [hereinafter 1980 HOUSE REPORT]. See also SEC, REPORT ON THE PUBLIC POLICY IMPLICATIONS OF INVESTMENT COMPANY GROWTH, H.R. REP. NO. 2337, 89th Cong., 2d Sess. 34-35 (1966) [hereinafter PPI REPORT] ("[t]he Act is also limited to companies in which there is a significant public interest, since it excludes from its coverage a company that has no more than 100 security holders and is neither making nor presently proposing to make a public offering of its securities") (footnotes omitted).

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somewhat arbitrary, reasonably reflects the point at which an issuer should not be regarded as a public investment company." As David Schenker, the Chief Counsel to the Commission's Investment Trust Study, explained

You have the situation where there are personal holding companies. A family may have a substantial estate and has invested its money in marketable securities. In essence that is a private investment company, is it not? We do not want any part of it; and so we have said that even though you engage in the same type of activity as an investment company, which is within the purview of this section, if you have less than 100 security holders you are not a public investment company and not within the purview of this legislation.<sup>12</sup>

The legislative history of section 3(c)(1) indicates that the 100 investor limit represents an outer limit of an investor base likely to be composed of people with personal, familial, or similar ties. In some circumstances, investor protection concerns may be raised by small investment pools whose securities are held by investors of modest means, even if the pools have fewer than 100 investors. But the concept that the investors in these smaller pools are bound by personal or familial ties retains some validity, and, in any case, federal oversight of these pools under the Investment Company Act would be impractical.

To prevent circumvention of the 100 investor limit, section 3(c)(1) currently includes a two-part attribution provision that, in some instances, requires an entity seeking to rely on the exception to "look through" its security holders to their underlying investors. The attribution provision is most easily explained by a sample fact situation. Assume Company B is seeking to rely on section 3(c)(1). If one of Company B's security holders, Company A, beneficially owns ten percent or more of the voting securities of Company B, then the security holders

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**"In a 1941 opinion, the Commission observed that the 100 investor limit "obviously is an arbitrary figure." In re Maritime Corp., 9 S.E.C. 906, 909 n.2 (1941).**

<sup>12</sup>*Investment Trusts and Investment Companies: Hearings on S. 3580 Before a Subcomm. of the Senate Comm. on Banking and Currency, 76th Cong., 3d Sess. 179 (1940).*

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of Company A are counted as security holders of Company B (*part I of the attribution provision*), unless Company A has no more than ten percent of its assets in securities of section 3(c)(1) issuers (*part II*).<sup>13</sup>

This two-part attribution provision is also pivotal in determining which section 3(c)(1) issuers are deemed to be investment companies for purposes of section 12(d)(1). Section 12(d)(1) is intended to restrict the pyramiding of funds by limiting the purchase of registered investment company securities by any investment company (whether or not registered), and the purchase of securities of any investment company (whether or not registered) by registered investment companies.<sup>14</sup> Unlimited pyramiding raises public policy concerns because a fund acquiring another fund's securities could exercise undue influence over that fund or disrupt its orderly management through the threat of redemption. Pyramiding also may result in a layering of costs to investors through duplicate administrative expenses, sales charges, and advisory fees without providing any significant benefit.<sup>15</sup>

Under current section 3(c)(1), only those issuers that would be investment companies but for the second part of that section's attribution provision (*i.e.*, they have large security holders, but those holders do not have more than ten percent of their assets in securities of section 3(c)(1) issuers) are deemed to be investment companies for the limited purposes of the anti-pyramiding restrictions in section 12(d)(1).<sup>16</sup> All other section 3(c)(1) issuers are not investment companies for the purposes of the anti-pyramiding restrictions of section 12(d)(1).

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<sup>13</sup>Prior to 1980, the attribution provision was more restrictive in that the 10% restriction was applied across the board. That is, beneficial ownership of 10% or more of Company B's outstanding voting securities was deemed to be beneficial ownership by all of the security holders of Company A, without exception.

<sup>14</sup>Section 12(d)(1) prohibits such purchases if, after the purchase, the acquiring company and any company or companies controlled by it own (i) more than three percent of the total outstanding voting stock of the acquired company; (ii) securities issued by the acquired company having an aggregate value of more than five percent of the total assets of the acquiring company; or (iii) securities issued by the acquired company and all other investment companies having an aggregate value of more than ten percent of the total assets of the acquiring company.

<sup>15</sup>PPI REPORT, *supra* note 10, at 311-24. The PPI Report noted the benefit of the fund holding company structure as a vehicle to achieve diversification was largely "illusory." *Id.* See *infra* note 22.

<sup>16</sup>The anti-pyramiding restriction in section 3(c)(1) was added in 1980, when the attribution provision was narrowed. SMALL BUSINESS SECURITIES ACTS AMENDMENTS OF 1980, S. REP. NO. 958, 96th Cong., 2d Sess. 20 (1980); 1980 HOUSE REPORT, *supra* note 10.

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The two-part attribution provision in section 3(c)(1) is both overly broad and extremely confusing. In many instances, the current test exaggerates public interest by counting the security holders of corporate investors when these security holders do not have a significant economic interest in a section 3(c)(1) issuer's performance. Moreover, investments in section 3(c)(1) issuers by companies which are not themselves investment companies (whether or not registered) generally do not, standing alone, implicate the concerns respecting the layering of intermediaries that the attribution test is intended to address. Put another way, if an intermediate investing entity is not itself a registered investment company or a private investment company, attribution is unnecessary.

Thus, we recommend an amendment to narrow the attribution provision. Under our proposal, if Company A, the intermediate investing entity, is itself not an investment company as defined in section 3 of the Investment Company Act, or is not relying on the section 3(c)(1) private investment company exception or the new "qualified purchaser" exception we propose below, Company A's security holders would not be counted for purposes of the 100 investor limit.<sup>17</sup>

In connection with this change, we recommend a related amendment to section 3(a)(3) of the Act to provide that the securities of a majority-owned subsidiary relying on section 3(c)(1) would not be excluded from the definition of "investment securities" under section 3(a)(3). This amendment would preclude a company that would itself fall within the definition of an investment company under section 3(a)(3) from avoiding regulation under the Act through investment in a section 3(c)(1) subsidiary.<sup>18</sup>

In addition, the Division believes that investments by registered investment companies in section 3(c)(1) issuers should not be constrained by section 12(d)(1). Any anti-pyramiding concerns raised in this context are minimized by the other provisions of the Act regulating the conduct of registered funds. Investments by

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<sup>17</sup>More specifically, the Division recommends legislation to narrow the attribution provision to provide that if an issuer seeking to rely on section 3(c)(1) has a 10% holder of the issuer's voting securities that: (i) is a registered investment company pursuant to section 3, or (ii) is itself an excepted section 3(c)(1) private investment company, or (iii) is a proposed section 3(c)(7) investment company whose securities exclusively are held by sophisticated investors, the issuer must count the security holders of the 10% holder of the issuer's voting securities as its own.

<sup>18</sup>Section 3(a)(3) generally provides that an investment company includes any company with more than 40% of its assets in investment securities. The definition of investment securities under section 3(a)(3) excludes, among other things, securities issued by majority-owned subsidiaries that are not investment companies; because of the section 3(c)(1) exclusion, the securities of a majority-owned section 3(c)(1) issuer are not investment securities. In light of the proposed change in the attribution provision and in the absence of the recommended amendment to section 3(a)(3), companies could avoid regulation under the Act by "downstreaming" their investment activities through a section 3(c)(1) subsidiary.

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registered investment companies in section 3(c)(1) issuers, for example, are governed by the conflict-of-interest provisions of section 17 of the Act<sup>19</sup> as well as those concerning breaches of fiduciary duty by the registered company's investment adviser under section 36.<sup>20</sup> The latter could come into play where investments in section 3(c)(1) issuers result in unnecessary duplication of fees or expenses. Moreover, as a result of the recommended change in section 3(c)(1)'s attribution provision, a registered fund's investment would be limited to ten percent of any one section 3(c)(1) issuer.<sup>21</sup> Removing section 12(d)(1)'s restrictions in connection with investments by registered investment companies in section 3(c)(1) issuers would eliminate unnecessary constraints without compromising important investor **protections**.<sup>22</sup>

The Division believes, on the other hand, that limitations on the ability of *all* section 3(c)(1) issuers to invest in registered investment companies are necessary to protect the public shareholders of registered investment companies. Private issuers, excepted from regulation under the Act, could acquire controlling interests and exert undue influence over registered funds, disrupting their portfolio management through the threat of redemption.<sup>23</sup>

Accordingly, the Division recommends amendment of section 3(c)(1) to eliminate application of section 12(d)(1) in connection with investments by registered investment companies, but to require that all section 3(c)(1) issuers be subject to section 12(d)(1)'s restrictions governing the purchase of registered investment company securities.<sup>24</sup>

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<sup>19</sup>15 U.S.C. § 80a-17.

<sup>20</sup>15 U.S.C. § 80a-35

<sup>21</sup>The amended attribution provision would count toward the 100 investor limit, without exception, the shareholders of **an** investment company owning 10% or more of a section 3(c)(1) issuer; as a result, the issuer would not be eligible for the private investment company exception.

<sup>22</sup>The diversification benefits derived from inter-fund investments depend largely on the investment objective and policies of the issuer in which the investment is made. Because private investment companies often offer specialized investment services, investment in these vehicles may enable the shareholders of registered funds to benefit from such services.

<sup>23</sup>While similar concerns are manifested whenever large institutional security holders threaten to redeem, the threat is compounded when the redeeming security holder is an investment company that must in **turn** meet its own redemption requests. PPI REPORT, supra note 10.

<sup>24</sup>To cover the other side of transactions involving open-end funds, section 12(d)(1) also would apply to a registered open-end investment company's sale of its securities to a section 3(c)(1) issuer. The application of section 12(d)(1) to all section 3(c)(1) issuers under the proposal would not affect existing holdings in registered investment companies, since section 12(d)(1) prohibits  
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The proposed amendments to section 3(c)(1) would facilitate participation in private issuers. As a result of the revised attribution provision, section 3(c)(1) would not limit investments by corporate, non-investment company investors. In the case of registered investment companies, the combined effect of the proposed changes to the attribution provision and the application of section 12(d)(1) would be to raise the limit on registered investment company purchases of private issuers from three percent to ten percent of any one such issuer.<sup>25</sup>

## 111. A Qualified Purchaser Exception

In contrast to the existing private investment company exception, 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.<sup>26</sup> As an alternative to the more narrow section 3(c)(1), such an exception could be relied upon by venture capital funds and other vehicles to increase funding available for small businesses as well as larger concerns.

Accordingly, the Division recommends amendment of the Investment Company Act to add a new section -- section 3(c)(7) -- to except from the Act any

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<sup>24</sup>(...continued)

only purchases or other acquisitions that cause holdings to exceed the numerical limits in the section.

<sup>25</sup>As indicated *supra* notes 14-16 and accompanying text, section 12(d)(1) currently limits investments by a registered fund to no more than three percent of any one private issuer that has a security holder owning ten percent or more of the issuer's voting securities.

<sup>26</sup>The Commission's release soliciting comments on the reform of investment companies specifically requested comment on whether the private investment company exception should be expanded to include entities that sell their securities to an unlimited number of institutional security holders. Request for Comments on Reform of the Regulation of Investment Companies, Investment Company Act Release No. 17534 (June 15, 1990), 55 FR 25322 [hereinafter Study Release]. Commenters addressing this issue generally supported an expansion, although they differed on how best to implement the change. The commenters included Aetna Life Insurance Company; the American Council of Life Insurance; Bankers Trust Company; The Chase Manhattan Bank, N.A.; Chemical Bank; Citicorp; Cleary, Gottlieb, Steen & Hamilton; Davis Polk & Wardwell; Dechert Price & Rhoads; The Equitable Life Assurance Society of the United States; Fidelity Management & Research Company; IDS Financial Services, Inc.; the Investment Company Institute; Levitt Greenberg Kaufman & Goldstein, P.C.; certain members of The Federal Regulation of Securities Committee of the Los Angeles County Bar Association; Merrill Lynch & Co., Inc.; The New York Clearing House Association; PaineWebber Development Corporation; Paloma Partners Management Company Inc.; Ropes & Gray; **S.G.** Warburg & Co., Inc.; Shearson Lehman Brothers Inc.; Skadden, Arps, Slate, Meagher & Flom; State Street Bank and Trust Company; Stradley, Ronon, Stevens & Young (on behalf of DFA Investment Dimensions Group Inc. and Dimensional Fund Advisors Inc.); The Vanguard Group, Inc.; and Weil, Gotshal & Manges.

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issuer whose securities are beneficially owned exclusively by one or more persons who, at the time of acquisition, are "qualified purchasers." There would be no limit on the number of investors or a prohibition on public offerings, provided the issuer's securities were sold to "qualified purchasers." To protect the public shareholders of registered investment companies, we recommend that the restrictions of section 12(d)(1) apply to investments by proposed section 3(c)(7) issuers in registered investment companies for the same reasons as issuers relying on section 3(c)(1).<sup>28</sup> As in the case of the section 3(c)(1) exception, we also recommend amendment of section 3(a)(3) of the Act to prevent companies from avoiding Investment Company Act regulation through investments in subsidiaries that qualify as section 3(c)(7) issuers.<sup>29</sup>

To implement the new exception, we also propose the adoption of a new section 2(a)(51) to define qualified purchaser to be any person so defined by rule, based on such factors as financial sophistication, net worth, knowledge and experience in financial matters, amount of assets owned or under management, relationship with the issuer, or such other factors as the Commission determines to be within the intent of the section? This approach would enable the Commission to respond to changing financial conditions and to benefit from the public comment process.

While the class of investors for a sophisticated investor exception would have to be defined adequately to ensure that investors are capable of safeguarding their interests, the idea that some investors do not need the protections of the federal securities laws is certainly not novel. A number of exemptive or safe harbor provisions under the federal securities laws are based, in part, on the degree of sophistication of investors. The three most noteworthy are section 4(6)

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<sup>27</sup>Evaluating a security holder's status at the time of acquisition would ensure that subsequent changes in the holder's net worth or other attributes would not result in the issuer inadvertently becoming an investment company.

<sup>28</sup>See *supra* notes 14-15 & 23 and accompanying text.

<sup>29</sup>See *supra* note 18 and accompanying text.

<sup>30</sup>An attribution provision designed to preclude circumvention of the qualified purchaser standard is unnecessary, since any concerns about evasion of the requirements of the exception could be addressed adequately in rulemaking. In defining eligible investors, the Commission also could decide to provide reasonable care defenses similar to those in Regulation D and rule 144A.

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of the Securities Act,<sup>31</sup> rule 144A under that Act,<sup>32</sup> and rule 205-3<sup>33</sup> under the Advisers Act.<sup>34</sup>

For example, section 4(6) of the Securities Act exempts from the registration requirements of that Act transactions involving offers or sales by an issuer solely to one or more "accredited investors," if the aggregate offering price of the issue does not exceed \$5 million, there is no advertising or public solicitation in connection with the transaction, and the issuer files a prescribed notice with the Commission. For purposes of section 4(6), an "accredited investor," as defined in section 2(15) of the Securities Act,<sup>35</sup> includes all banks (whether acting in an individual or fiduciary capacity), insurance companies, registered investment companies, business development companies, and small business investment companies. The term also includes any employee benefit plan, including an individual retirement account, subject to the provisions of the Employee Retirement Income Security Act of 1974 ("ERISA")<sup>36</sup> if the investment decision is made by a plan fiduciary that is either a bank, insurance company, or registered investment adviser.

The Commission also may designate other persons as accredited investors on the basis of such factors as financial sophistication, net worth, knowledge and experience in financial matters, or amount of assets under management.<sup>37</sup> In Regulation D, an "accredited investor" also is defined to include, among other things, any state or local government employee benefit plan with total assets in excess of \$5 million, any ERISA plan if the investment decision is made by a plan fiduciary that is either a bank, a savings and loan association, insurance company, or registered investment adviser, or if the plan has total assets in excess of \$5 million, corporations, business trusts, partnerships, or charitable organizations with total assets in excess of \$5 million, executive officers and directors of the issuer, private business development companies, natural persons with a net worth (or joint net worth with a spouse) of \$1 million, and natural persons with individual income of \$200,000 in each of the last two years or joint income with

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<sup>31</sup>15 U.S.C. § 77d(6).

<sup>32</sup>17 C.F.R. § 230.144A.

<sup>33</sup>17 C.F.R. § 275.205-3.

<sup>34</sup>Investment Advisers Act of 1940, 15 U.S.C. § 80b.

<sup>35</sup>15 U.S.C. § 77b(15).

<sup>36</sup>Employee Retirement Income Security Act of 1974, 29 U.S.C. § 1001.

<sup>37</sup>Securities Act § 2(15)(ii), 15 U.S.C. § 77b(15)(ii).

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a spouse in excess of \$300,000 and a reasonable expectation of reaching that income level in the current year.<sup>38</sup>

Rule 144A under the Securities Act provides a non-exclusive safe harbor for resales of restricted securities to "qualified institutional buyers." Qualified institutional buyers include (1) certain types of institutional purchasers that own and invest on a discretionary basis at least \$100 million in securities, including any insurance company, investment company, business development company, small business investment company, state plan, employee benefit plan, charitable organization, corporation, partnership, business trust, or investment adviser; (2) any registered dealer that owns and invests on a discretionary basis at least \$10 million in securities; any registered investment company that is part of a family of investment companies with at least \$100 million in securities; and (3) any bank or savings and loan that owns and invests at least \$100 million and has an audited net worth of at least \$25 million. In addition, Rule 205-3 exempts from the restrictions on performance-based advisory fees in section 205 of the Advisers Act<sup>39</sup> certain contracts with sophisticated clients, including advisory clients with at least \$500,000 under management with the adviser and clients with a net worth of at least \$1,000,000.

Given the many risks to investors of committing assets to managed pools, the Division believes the ability to evaluate unregulated investment companies requires a high degree of sophistication. Consequently, we believe that an accredited investor standard would be too low,<sup>40</sup> and that, at least initially, the definition of qualified institutional buyer in rule 144A would represent an appropriate level of sophistication for institutions. We also believe that a standard could be developed to permit certain natural persons to invest in proposed section 3(c)(7) issuers; where such persons possess a high degree of

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<sup>38</sup>17 C.F.R. § 230.501(a).

<sup>39</sup>15 U.S.C. § 80b-5.

<sup>40</sup>In response to the Study Release (supra note 26), most proponents of a new exception favored an accredited investor standard. See, e.g., Letter of the American Council of Life Insurance to Jonathan G. Katz, Secretary, SEC 75-78 (Oct. 10, 1990), File No. S7-11-90; Letter from Merrill Lynch & Co., Inc. to Jonathan G. Katz, Secretary, SEC VII-1 to 8 (Oct. 18, 1990), File No. S7-11-90 ("Merrill Lynch Study Comment"); Letter of Weil, Gotshal & Manges to Jonathan G. Katz, Secretary, SEC (Oct. 9, 1990), File No. S7-11-90. Others commenters favored a qualified institutional buyer standard. See Letter of Cleary, Gottlieb, Steen & Hamilton to Jonathan G. Katz, Secretary, SEC 14-17 (Oct. 12, 1990), File No. S7-11-90; Memorandum of the Investment Company Institute, Amendment of Section 3(c)(1) of the Investment Company Act of 1940-11 (undated), File No. S7-11-90; Letter of Ropes & Gray to Jonathan G. Katz, Secretary, SEC 4 (Oct. 9, 1990), File No. S7-11-90.

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financial sophistication, they would be fully capable of evaluating and assuming the risks associated with the new section 3(c)(7) pools.

Of course, many investors who would be able to invest in the new section 3(c)(7) issuers nevertheless may choose to invest instead in registered investment companies, relying on the protections afforded by the existing regulatory structure. Some institutional investors are limited by law as to the types of investments that they may make, and may be required to invest only in registered investment companies. Moreover, fiduciaries may be reluctant to take the risks associated with investments in unregistered investment companies and may choose instead to invest only in registered companies. Our recommendation, if implemented, would not limit the access of large investors to registered investment companies.

#### **IV. Other Options Considered**

In response to the Commission's solicitation of comments on reform of the regulation of investment companies,<sup>41</sup> commenters favoring a sophisticated investor exception generally asserted that funds sold exclusively or primarily to sophisticated investors should be excepted from all provisions of the Act. A few, however, argued that such companies should be registered and remain subject to some of the Act's requirements if they have more than 100 security holders.<sup>42</sup> The Division believes no sufficiently useful governmental purpose is served by

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<sup>41</sup>Study Release, *supra* note 26.

<sup>42</sup>One commenter recommended the elimination or modification of a number of the regulatory requirements of the Act for funds offered only to sophisticated investors, including the corporate governance provisions of section 16 (15 U.S.C. § 80a-16), the capital structure limitations of section 18 (15 U.S.C. § 80a-18), the restrictions on the timing of redemptions in section 22(e) (15 U.S.C. § 80a-22(e)), and the restrictions on affiliated transactions in section 17. Letter from Paul A. Hilstad, Vice President and Deputy General Counsel, IDS Financial Services, Inc., to Jonathan G. Katz, Secretary, SEC 25 (Oct. 2, 1990), File No. 57-11-90. Another commenter stated that "registration of institutional funds under the 1940 Act must continue," so that such funds will get pass-through tax treatment under Subchapter M of the Internal Revenue Code, but recommended the funds be exempt from certain portions of section 5 (15 U.S.C. § 80a-5) (definition of diversified company), section 12 (margin purchases and fund holding companies), section 13 (15 U.S.C. § 80a-13) (certain shareholder approval requirements), section 18 (redemptions in kind), section 22 (daily calculation of net asset value), and section 30 (15 U.S.C. 80a-29) (listing of portfolio holdings). Letter from Stephen W. Kline, Stradley, Ronon, Stevens & Young, on behalf of DFA Investment Dimensions Group, Inc. and Dimensional Fund Advisors, Inc., to Jonathan G. Katz, Secretary, SEC (Oct. 12, 1990), File No. S7-11-90. We believe that private investment companies would use an expanded exception, even if Subchapter M is not available to them. A number of issuers now avail themselves of section 3(c)(1), apparently finding a way to obtain acceptable tax treatment, either by organizing as limited partnerships or some other means.

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continuing to regulate funds owned exclusively by sophisticated investors.<sup>43</sup> Moreover, even limited Commission jurisdiction could lead to unrealistic assumptions on the part of investors concerning the ability of the Commission to police private investment companies.<sup>44</sup>

Proponents of a sophisticated investor exception also suggested two other approaches to accommodating increased participation by sophisticated investors. After consideration, we believe that these proposals are less desirable than the approach we recommend.

One approach would be to amend section 3(c)(1) to resemble section 4(2) of the Securities Act, which exempts from the registration requirements of that Act transactions by an issuer not involving a public offering.<sup>45</sup> Under this approach, the 100 investor limit in section 3(c)(1) would be deleted, thus making the exception available to any fund not making or presently proposing to make a public offering.<sup>46</sup>

The second approach would be to exclude sophisticated investors from counting towards the 100 investor limit in section 3(c)(1). Under this approach, a fund could have an unlimited number of sophisticated investors and rely on section 3(c)(1) so long as it had no more than 100 other participants.

We believe the 100 investor limit in the current private investment company exception reasonably reflects the point at which federal regulatory concerns are raised if any unsophisticated investors are involved. The 100 investor limit is an effective proxy for requiring that the investors have some relationship outside the pool, such as familial or social ties. To simply focus on

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<sup>43</sup>The Commission would continue to have the ability to monitor the securities trades of large private investment companies under sections 13(f) and 13(h) of the Securities Exchange Act of 1934 (15 U.S.C. §§ 78m(f) and 78m(h)).

<sup>44</sup>Of course, even if funds owned by more than 100 sophisticated investors were excepted from all of the Act, the Commission would retain the jurisdiction and responsibility under the Securities Act, the Exchange Act, and the Advisers Act to police securities fraud perpetrated by private investment companies and their sponsors.

<sup>45</sup>See, e.g., Letter from Davis Polk & Wardwell to Jonathan G. Katz, Secretary, SEC 36-40 (Oct. 10, 1990), File No. S7-11-90. One commenter suggested that an exception for issuers that sell exclusively to sophisticated investors should not turn on whether the issuer conducted a public offering, but only on whether the offering was a "directed public offering" to unsophisticated investors. Merrill Lynch Study Comment, *supra* note 40, at Ex. VII-6. The definition of "directed public offering" was derived from Regulation S (17 C.F.R. § 230.901) under the Securities Act, which defines "directed selling efforts" and "overseas directed offering." 17 C.F.R. § 230.902.

<sup>46</sup>Of course, there would also have to be a prohibition on ever having made a public offering. Otherwise, an issuer could deregister whenever it completed its initial public offering.

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whether or not an issuer had ever conducted a public offering would ignore that repeated private offerings or secondary market transactions could result in a supposedly private issuer being owned by significant numbers of unsophisticated investors. And to suggest that unsophisticated investors would rely, when participating in these unregulated pools, upon the expertise and bargaining power of participating sophisticated investors, rather than their own resources, merely identifies additional risks that implicate the public interest. Thus, given the risks for the financially unsophisticated, we believe **such** pools should be registered under the Act. In comparison, pools owned exclusively by sophisticated investors do not present these concerns, regardless **of** the number of investors.

## **V. Conclusion**

The Division recommends amendment of the Investment Company Act to create a new exception for funds whose securities are owned exclusively by qualified purchasers, as defined by rule. The Division also recommends that the current attribution provision in section 3(c)(1) be narrowed, and that section 3(a)(3) be amended to prevent a circumvention of the Act through investments in issuers relying on section 3(c)(1) or section 3(c)(7). Finally, the Division believes that the anti-pyramiding restrictions of section 3(c)(1) should be revised to govern all private issuers seeking to invest in the securities of registered investment companies.

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## APPENDIX 2-A

### Red-Lined Version of Proposed Amendments to the Investment Company Act of 1940

(new language is shaded, ~~language is struck through~~)

Section 2(a) [15 U.S.C. § 80a-2(a)]. When used in this title, unless the context otherwise requires —

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(5) “Qualified purchaser” means any person whom the Commission, by rule or regulation, shall have determined not to need the protections of this title on the basis of such factors as financial sophistication, net worth, knowledge and experience in financial matters, amount of assets owned or under management, relationship with an issuer, or such other factors as the Commission may determine to be within the intent of this definition.

Section 3(a) [15 U.S.C. § 80a-3(a)]. When used in this title, “investment company” means any issuer which--

(3) is engaged or proposes to engage in the business of investing, reinvesting, owning, holding, or trading in securities, and owns or proposes to acquire investment securities having a value exceeding 40 per centum of the value of such issuer’s total assets (exclusive of Government securities and cash items) on an unconsolidated basis.

As used in this section, “investment securities” includes all securities except (A) Government securities, (B) securities issued by employees’ securities companies, and (C) securities issued by majority-owned subsidiaries of the owner which are not investment companies or excluded from the definition of investment company solely by virtue of section 3(c)(1) or section 3(c)(7) of the Act.

Section 3(c) [15 U.S.C. § 80a-3(c)]. Notwithstanding subsection (a), none of the following persons is an investment company within the meaning of this title:

(1) Any issuer whose outstanding securities (other than short-term paper) are beneficially owned by not more than one hundred persons and which is not making and does not presently propose to make a public offering of its securities. Such issuer nonetheless is deemed to be an investment company for purposes of the limitations set forth in section 12(d)(1) governing the purchase or other acquisition by such issuer of any security issued by any registered investment company, and the

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sale of any security issued by any registered open-end investment company to any such issuer. For the purposes of this paragraph:

(A) Beneficial ownership by a company shall be deemed to be beneficial ownership by one person, except that, if such company owns 10 percentum or more of the outstanding voting securities of the issuer, and is or, but for the exception in this paragraph or paragraph (7), would be an investment company, the beneficial ownership shall be deemed to be that of the holders of such company's outstanding securities (other than short-term paper). ~~unless, as of the date of the most recent acquisition by such company of securities of that issuer, the value of all securities owned by such company of all issuers which are or would, but for the exception set forth in this subparagraph, be excluded from the definition of investment company solely by this paragraph, does not exceed 10 percentum of the value of the company's total assets. Such issuer nonetheless is deemed to be an investment company for purposes of section 12(d)(1).~~

(B) Beneficial ownership by any person who acquires securities or interests in securities of an issuer described in the first sentence of this paragraph shall be deemed to be beneficial ownership by the person from whom such transfer was made, pursuant to such rules and regulations as the Commission shall prescribe as necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of this title, where the transfer was caused by legal separation, divorce, death, or other involuntary event.

\* \* \*

(7) ~~Reserved: Any issuer whose outstanding securities are owned exclusively by persons who, at the time of acquisition of such securities, are qualified purchasers. Such issuer nonetheless is deemed to be an investment company for purposes of the limitations set forth in section 12(d)(1) governing the purchase or other acquisition by such issuer of any security issued by any registered investment company, and the sale of any security issued by any registered open-end investment company to any such issuer.~~