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RESPONSE OF THE OFFICE OF CHIEF COUNSEL
DIVISION OF INVESTMENT MANAGEMENT

Your letter of December 3, 1997 requests our views regarding a number of issues under Sections 3(c)(1), 3(c)(7) and 2(a)(51)(A) of the Investment Company Act of 1940 ("Investment Company Act"), and Rules 2a51-1, 2a51-3, 3c-5 and 3c-6 under that Act. Specifically, you ask that we respond to the questions set forth below.[1]

BACKGROUND

The National Securities Markets Improvement Act of 1996 (the "1996 Act")

Your questions are prompted by the passage of the 1996 Act, which, among other things, contained a number of provisions that relate to the treatment of certain privately offered investment pools that are excluded from the definition of investment company under the Investment Company Act ("private investment companies"). First, the 1996 Act added Section 3(c)(7) to the Investment Company Act to exclude from the definition of investment company any issuer whose outstanding securities are owned by persons who, at the time of acquisition of the securities, are qualified purchasers, and which is not making and does not at that time propose to make a public offering of its securities ("Section 3(c)(7) Fund"). The exclusion provided by Section 3(c)(7) reflects Congress's recognition that financially sophisticated investors are in a position to appreciate the risks associated with certain investment pools and do not need the protections of the Investment Company Act.[2]

The 1996 Act added Section 2(a)(51) to the Investment Company Act to define the term "qualified purchaser" for purposes of Section 3(c)(7). That section generally defines a qualified purchaser to be: (i) any natural person (including any person who holds a joint, community property, or other similar shared ownership interest in a Section 3(c)(7) Fund with that person's qualified purchaser spouse) who owns not less than $5 million in invest-

[1]You have not asked, and this letter does not address, issues that your questions may raise under the other federal securities laws.

[2]S. Rep. No. 293, 104th Cong., 2d Sess. 10 (1996) ("Senate Report") ("Generally, these investors can 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").

ments; (ii) any family-owned company[3] that owns not less than $5 million in investments; (iii) any trust that is not covered by clause (ii) and was not formed for the specific purpose of acquiring the securities, the trustee and settlor of which are qualified purchasers; and (iv) any person, acting for its own account or the accounts of other qualified purchasers, that owns and invests on a discretionary basis not less than $25 million in investments.

The 1996 Act also amended Section 3(c)(1) of the Investment Company Act, which excludes from the definition of investment company any issuer whose outstanding securities (other than short-term paper) are owned by not more than 100 beneficial owners and which is not making and does not propose to make a public offering of its securities ("Section 3(c)(1) Fund"). The 1996 Act simplified the way in which the number of beneficial owners in a Section 3(c)(1) Fund is calculated for purposes of the 100-owner limit by no longer requiring the Fund to "look-through" certain companies (*e.g.*, corporations, partnerships and other investors that are not natural persons) that hold its voting securities and count that company's security holders as beneficial owners of the Fund's securities. As amended, Section 3(c)(1) treats beneficial ownership by a company for purposes of the 100-owner limit as beneficial ownership by one person unless the company (i) owns 10 percent or more of the Section 3(c)(1) Fund's voting securities and (ii) is or, but for the exclusion provided by Section 3(c)(1) or Section 3(c)(7), would be an investment company (the "Look-Through Provision").

Finally, Section 3(c)(7) includes a provision that permits an existing Section 3(c)(1) Fund to convert into a Section 3(c)(7) Fund ("Grandfathered Fund"). Under this provision ("Grandfather Provision"), the outstanding securities of a Grandfathered Fund may be beneficially owned by as many as 100 persons that are not qualified purchasers ("grandfathered investors"), provided that these persons acquired the securities of the Grandfathered Fund on or before September 1, 1996, and certain other requirements, designed to protect the Section 3(c)(1) Fund's existing beneficial owners, are satisfied.[4]

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[3]A family-owned company for purposes of this section is a company "that is owned directly or indirectly by or for 2 or more natural persons who are related as siblings or spouse (including former spouses), or direct lineal descendants by birth or adoption, spouses of such persons, the estates of such persons, or foundations, charitable organizations, or trusts established by or for the benefit of such persons."

[4]Specifically, the Grandfather Provision requires the Grandfathered Fund, prior to conversion, to provide each beneficial owner of its securities with notice of the Fund's intention to become a Section 3(c)(7) Fund and a reasonable opportunity to redeem the owner's interest in the Fund.

With respect to the treatment of private investment companies, the 1996 Act also contained provisions (i) requiring an existing Section 3(c)(1) Fund that wishes to become a qualified purchaser to obtain the consent of certain beneficial owners of its securities and

Commission Rulemaking

In April 1997, the Commission adopted several rules under the Investment Company Act to implement the provisions of the 1996 Act that relate to private investment companies.[5] Rule 2a51-1 defines the term "investments" for purposes of Section 2(a)(51) and clarifies how the value of a qualified purchaser's investments should be calculated. Rule 2a51-2 defines the term "beneficial owner" for purposes of the Grandfather Provision.[6] Rule 2a51-3 provides that (i) a company may not be deemed to be a qualified purchaser under Sections 2(a)(51)(A)(ii) and (iv) if it was formed for the specific purpose of acquiring the securities issued by a Section 3(c)(7) Fund unless each beneficial owner of the company's securities is a qualified purchaser, and (ii) a company may be deemed to be a qualified purchaser if each beneficial owner of the company's securities is a qualified purchaser.

As directed by the 1996 Act, the Commission adopted two other rules that relate to private investment companies. Rule 3c-5 generally permits knowledgeable employees of a Section 3(c)(1) Fund, and a company owned exclusively by such knowledgeable employees, to acquire securities issued by the Fund without being counted as beneficial owners of the Fund for purposes of the Section 3(c)(1) 100-owner limit. The rule also permits knowledgeable employees of a Section 3(c)(7) Fund, and a company owned exclusively by such knowledgeable employees, to acquire securities issued by that Fund without being qualified purchasers. Rule 3c-5 was promulgated pursuant to Congress's directive that the Commission prescribe rules permitting knowledgeable employees of a Section 3(c)(1) Fund or a Section 3(c)(7) Fund to own securities issued by the Fund without the Fund losing its exclusion under Sections 3(c)(1) or 3(c)(7).[7]

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certain other persons; (ii) imposing the investment restrictions of Sections 12(d)(1)(A)(i) and (B)(i) of the Investment Company Act on all Section 3(c)(1) Funds and Section 3(c)(7) Funds, but only in connection with transactions involving securities issued by registered investment companies; and (iii) prohibiting a Section 3(c)(1) Fund from being integrated with a Section 3(c)(7) Fund for purposes of determining whether either Fund meets its exemption. Your letter does not request our views with respect to these provisions.

[5]Privately Offered Investment Companies, Investment Company Act Release No. 22597 (Apr. 3, 1997), 62 FR 17512 (Apr. 9, 1997) ("Adopting Release").

[6]Similarly, the Commission adopted Rule 3c-1 to define the term "beneficial ownership" with respect to certain Section 3(c)(1) Funds, effectively permitting such Funds to rely on the pre-1996 provisions of Section 3(c)(1) rather than restructure their existing relationships with investors. None of your questions, however, relates to either Rule 3c-1.or Rule 2a51-2.

[7]Section 209(d)(3) of the 1996 Act.

Rule 3c-6 generally addresses transfers of securities issued by private investment companies for estate planning purposes and in certain other circumstances. The rule provides that beneficial ownership by a person who acquired securities ("Transferee") issued by a Section 3(c)(1) Fund from a person other than the Section 3(c)(1) Fund will be deemed to be beneficial ownership by the person from whom the transfer was made ("Transferor"), provided that the Transferee is the estate of the Transferor, a Donee (as that term is defined in the rule),[8] or a company established by the Transferor exclusively for the benefit of (or owned exclusively by) the Transferor and/or a Donee or the estate of the Transferor. The rule also provides that the securities issued by a Section 3(c)(7) Fund that are owned by a Transferee who received them from a qualified purchaser other than the Section 3(c)(7) Fund, or a person deemed to be a qualified purchaser under this rule (also "Transferor"), will be deemed to be acquired by a qualified purchaser, regardless of whether the Transferee is a qualified purchaser, provided that the Transferee is the estate of the Transferor, a Donee, or a company established by the Transferor exclusively for the benefit of (or owned exclusively by) the Transferor and/or a Donee or the estate of the Transferor. Rule 3c-6 was issued under Sections 3(c)(1)(B) and 3(c)(7)(A), both of which provide the Commission with rulemaking authority with respect to the transfer of securities issued by a Section 3(c)(1) Fund or a Section 3(c)(7) Fund when the transfer is the result of a "legal separation, divorce, death or other involuntary event."[9]

QUESTIONS AND ANSWERS[10]

A. Rule 3c-5: Knowledgeable Employees

Question 1: May certain marketing and investor relations professionals, research analysts, brokers and traders, attorneys, financial, compliance, operational and accounting officers of a Section 3(c)(1) Fund, a Section 3(c)(7) Fund or an Affiliated Management Person, who are non-executive employees of the Section 3(c)(1) Fund, the Section 3(c)(7) Fund, or Affiliated Management Person, qualify as knowledgeable employees?

Answer: Rule 3c-5 generally defines a "knowledgeable employee" of a Section 3(c)(1) Fund or a Section 3(c)(7) Fund to include certain executives of the Fund or an Affiliated Manage-

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[8]*See infra* note 48.

[9]Section 209(d)(1) of the 1996 Act directed the Commission to prescribe rules to implement the requirements of Section 3(c)(1)(B) no later than 1 year after the date of enactment of the 1996 Act. Although Section 3(c)(1)(B) was enacted in 1980, the Commission had not promulgated any rules implementing this section until it adopted Rule 3c-6. *See also infra*, text accompanying notes 56-58.

[10]The following questions are answered in the order in which they are asked.

ment Person of the Fund,[11] and non-executive employees of the Fund or an Affiliated Management Person of the Fund (other than clerical, secretarial or administrative employees) who, in connection with their regular functions or duties, participate in the investment activities of the Fund, any other Section 3(c)(1) Fund or Section 3(c)(7) Fund, or investment company the investment activities of which are managed by the Affiliated Management Person,[12] provided that the employees have been performing these functions and duties for, or on behalf of, the Fund or the Affiliated Management Person, or substantially similar functions or duties for, or on behalf of, another company for at least 12 months.

You argue that certain other non-executive employees may be close enough to the investment decision-making function to be viewed as participants in that process as a result of their evaluative abilities, the nature of their responsibilities, and the information that these employees may receive in the course of their regular functions or duties. You describe these employees as follows:

> (i) marketing and investor relations professionals who must explain potential and actual portfolio investments of a fund and the investment decision-making process and strategy being followed to clients and prospective investors and who, from time to time, interface among the fund, the portfolio managers and the fund's clients; (ii) research analysts who investigate the potential investments for the fund; (iii) attorneys who, as part of their duties, provide advice with respect to, or who participate in, the preparation of offering documents, and the negotiation of related agreements and who also are familiar with

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[11]These persons include any executive officer, director, trustee, general partner, advisory board member, or person serving in a similar capacity, of the Section 3(c)(1), the Section 3(c)(7) Fund or an Affiliated Management Person of the Fund. *See* Rule 3c-5(a)(4)(i).

[12]Rule 3c-5(a)(1) defines "Affiliated Management Person" as an affiliated person of the Fund, as defined in Section 2(a)(3) of the Investment Company Act, that manages the investment activities of a Section 3(c)(1) Fund or a Section 3(c)(7) Fund. Section 2(a)(3) defines the term "affiliated person" to include "any person directly or indirectly controlling, controlled by, or under common control with" another person, and any investment adviser to an investment company. For purposes of determining whether a person is an Affiliated Management Person, Rule 3c-5(a)(1) provides that the term "investment company" in Section 2(a)(3) includes a Section 3(c)(1) Fund or a Section 3(c)(7) Fund. Thus, an investment adviser to a Section 3(c)(1) Fund or a Section 3(c)(7) Fund would be considered to be an affiliated person of the Fund for purposes of determining whether the adviser was an Affiliated Management Person of the Fund. *See* PPM America Special Investments CBO II, L.P. (pub. avail. Apr. 16, 1998) ("PPM Letter"). *See also* Adopting Release, *supra* note 5, at n.122 and accompanying text (Commission refers to the Affiliated Management Person as "an affiliated person of the fund that oversees the fund's investments.").

investment company management issues and respond to questions or give advice concerning ongoing fund investments, operations and compliance matters; (iv) brokers and traders of a broker-dealer related to the [Section 3(c)(1) Fund/Section 3(c)(7) Fund] or the Affiliated Management Person who are Series 7 registered; and (v) financial, compliance, operational and accounting officers of a fund who have management responsibilities for compliance, accounting and auditing functions of funds or their Management Affiliates.

Rule 3c-5 is intended to cover non-executive employees only if they actively participate in the investment activities of the Fund, any other Section 3(c)(1) Fund or Section 3(c)(7) Fund, or any investment company the investment activities of which are managed by the Fund's Affiliated Management Person. The rule thus is clearly intended to encompass persons who actively participate in the management of a Fund's investments.[13] The rule is not intended to include employees who merely obtain information regarding the investment activities of these Funds. The Commission initially proposed that the definition of knowledgeable employee include persons who, in connection with their regular functions or duties, obtain information regarding the investment activities of the Fund or investment companies managed by the Affiliated Management Person, but did not include such persons in the final rule because of a concern that these persons may not have any investment experience.[14]

Whether an employee actively participates in the investment activities of a Fund is a factual determination that must be made on a case-by-case basis by the Fund.[15] Nevertheless, as a general matter, with the possible exception of some research analysts (*e.g.*, a research analyst who researches all potential portfolio investments and provides recommendations to the portfolio manager), we believe that the types of employees described in your letter would not qualify as knowledgeable employees under Rule 3c-5.

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[13]Adopting Release, *supra* note 5, at text following n.127.

[14]*Id.*, at text following n.123 ("One commenter suggested that including employees who 'obtain information' regarding the investment activities could include employees, such as compliance personnel, who may not have any investment experience. The Commission agrees, and the rule as adopted includes only employees who 'participate in' the investment activities of the fund or other investment companies managed by the fund's Management Affiliate.").

[15]Consequently, the staff generally will not entertain any requests as to our views with respect to whether a particular employee or type of employee meets this aspect of the knowledgeable employee definition.

Question 2: May an employee who manages a fund that is not defined as an investment company under the Investment Company Act pursuant to an exclusion other than Section 3(c)(1) or Section 3(c)(7) be eligible for knowledgeable employee status?

Answer: Rule 3c-5 is premised on the belief that certain persons, because of their financial knowledge and sophistication and their relationship with the Section 3(c)(1) Fund or the Section 3(c)(7) Fund, do not need the protection of the Investment Company Act. To ensure that a knowledgeable employee has the appropriate level of financial knowledge and sophistication, Rule 3c-5 generally requires that knowledgeable employees participate in the investment activities of a Section 3(c)(1) Fund, a Section 3(c)(7) Fund, or any investment company the investment activities of which are managed by the Fund's Affiliated Management Person.[16]

The staff recently took the position that a person who participates in the investment activities of a company that would be regulated under the Investment Company Act but for the exclusion provided by Section 3(c)(3) of the Investment Company Act or the exemption provided by Rule 3a-6 under that Act[17] is as likely to be financially knowledgeable and sophisticated as a person who participates in the investment activities of a Section 3(c)(1) Fund, a Section 3(c)(7) Fund, or an investment company.[18] Therefore, the staff stated that it would not recommend that the Commission take any enforcement action under Section 7 of the Investment Company Act[19] if such a person is considered to be a knowledgeable employee under Rule 3c-5, notwithstanding the fact that the employee does not participate in the investment activities of a Section 3(c)(1) Fund, a Section 3(c)(7) Fund, or an investment company.

In addition, the staff takes the position that it is likely that a person who participates in the investment activities of a company that would be regulated under the Investment Company Act but for the exclusion provided by Section 3(c)(11) of the Act or Section 3(c)(2) of the Act is just as financially sophisticated and knowledgeable as a person who manages a Section 3(c)(1) Fund, a Section 3(c)(7) Fund, or an investment company. Therefore, the

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[16]As noted above, this requirement does not apply to certain executives of the Fund or the Affiliated Management Person of the Fund. *See supra* note 11.

[17]Section 3(c)(3) excludes banks, insurance companies, and certain other financial institutions from the definition of investment company. Rule 3a-6 exempts foreign banks and insurance companies.

[18]PPM Letter, *supra* note 12.

[19]Section 7 generally prohibits a domestic investment company from using U.S. jurisdictional means to offer or sell its securities unless the company is registered under Section 8 of the Investment Company Act.

staff would not recommend enforcement action under Section 7 if that person were considered to participate in the investment activities of an eligible entity under Rule 3c-5.[20]

Finally, you suggest that persons who participate in the investment activities of "foreign or offshore investment companies" also should be eligible for knowledgeable employee status. We agree. An investment company formed under the laws of a jurisdiction other than the United States and not registered under the Investment Company Act would nevertheless still be considered to be an "investment company" under the Investment Company Act. Thus, any person who participates in the investment activities of such a company may be considered to be a knowledgeable employee under Rule 3c-5.[21]

Question 3: May the definition of "Affiliated Management Person" of a Section 3(c)(1) Fund or a Section 3(c)(7) Fund include each affiliated entity of a Section 3(c)(1) Fund or a Section 3(c)(7) Fund (regardless of corporate structure) that participates in investment activities of the investment management company?

Answer: In promulgating Rule 3c-5, the Commission intended that knowledgeable employees be limited to persons whose employer managed the Section 3(c)(1) Fund or the Section 3(c)(7) Fund in which the persons wished to invest. This requirement was intended, in part, to ensure that knowledgeable employees have access to information about the management of the Section 3(c)(1) Fund or the Section 3(c)(7) Fund in which they wish to invest.[22] Rule

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[20]Section 3(c)(11) generally excludes from the definition of investment company certain tax-qualified pension or profit-sharing plans, any collective trust fund maintained by a bank that consists solely of assets of these plans, or any insurance company separate account the assets of which are derived from contributions under certain tax-qualified plans. Section 3(c)(2) generally excludes certain underwriters, brokers and market intermediaries from the definition of investment company. Because Rule 3c-5 refers to persons who participate in the "investment activities of a . . . company," our position with respect to Section 3(c)(2) companies is limited to those persons who participate in the investment activities of the companies' proprietary accounts.

[21]You also suggest that any "manager who manages only separately managed accounts (*e.g.*, not a fund)" should also be eligible for knowledgeable employee status. Whether such a person can be considered to be as financially sophisticated and knowledgeable as a person who manages a Section 3(c)(1) Fund, a Section 3(c)(7) Fund, or an investment company, would depend on the particular facts and circumstances. The staff generally will entertain requests as to whether a manager who manages only separately managed accounts could qualify, under a particular set of facts and circumstances, as a knowledgeable employee.

[22]*See* Adopting Release, *supra* note 5, at n.122 and accompanying text; PPM Letter, *supra* note 12.

3c-5 therefore provides that an investment adviser to a Section 3(c)(1) Fund or a Section 3(c)(7) Fund would be considered to be an affiliated person of the Fund for purposes of determining whether the adviser was an Affiliated Management Person of the Fund.

The staff recently took the position that, in certain circumstances, a company that is under common control with the investment adviser to a Section 3(c)(7) Fund may be considered to be an Affiliated Management Person of the Fund because an employee of such an entity generally will have significant access to information about the Fund.[23] The staff's position was based particularly on the facts that the company and the Fund's investment adviser were indirect, wholly owned subsidiaries of the same ultimate parent and that the company managed the investment activities of a company that would be an investment company but for the exclusion under Section 3(c)(3).[24] Whether an affiliate of a Section 3(c)(1) Fund or a Section 3(c)(7) Fund would be an Affiliated Management Person for purposes of determining whether its employees are knowledgeable employees generally would depend on the particular facts and circumstances.

Question 4: If a knowledgeable employee invests in a Section 3(c)(1) Fund or a Section 3(c)(7) Fund (i) jointly with a spouse and/or other dependents or (ii) through a family company trust or similar estate planning vehicle for which the knowledgeable employee is responsible for investment decisions and the source of the funds invested is individual property or property held jointly with the spouse, will such investment be deemed to have been made by the knowledgeable employee?

Answer: (i) In the Adopting Release, the Commission stated that, for purposes of determining the number of beneficial owners of the voting securities of a Section 3(c)(1) Fund, securities issued by the Section 3(c)(1) Fund that are jointly owned by an investor and his or her spouse would be considered to be owned by one beneficial owner.[25] Thus, securities issued by a Section 3(c)(1) Fund that are jointly owned by a knowledgeable employee and his or her spouse would be considered to be owned by one beneficial owner. On this basis, we would not count an investment that is jointly owned by a knowledgeable employee and his or her spouse towards the Fund's 100-owner limit because Rule 3c-5 permits a knowledgeable employee of a Section 3(c)(1) Fund to acquire securities of that Fund without being counted as a beneficial owner.

Furthermore, we take the position that a knowledgeable employee and his or her spouse who is not a knowledgeable employee (or a qualified purchaser) may invest jointly in

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[23] *See* PPM Letter, *supra* note 12.

[24] *Id.*

[25] Adopting Release, *supra* note 5, at n.69.

a Section 3(c)(7) Fund. Section 2(a)(51)(A)(i) includes as a qualified purchaser any natural person who owns $5 million in investments and that person's spouse if they invest jointly. Therefore, a spouse who is not a qualified purchaser can hold a joint interest in a Section 3(c)(7) Fund with his or her qualified purchaser spouse.[26] Although Section 2(a)(51)(A)(i) and Rule 3c-5 both pertain to persons who have the financial sophistication to understand and evaluate the risks associated with purchasing securities of an investment pool that is not regulated under the Investment Company Act, Rule 3c-5, unlike Section 2(a)(51)(A)(i), does not expressly permit a knowledgeable employee to invest in a Section 3(c)(7) Fund with his or her spouse who is not a knowledgeable employee (or qualified purchaser).

We believe that it would be consistent with Congress's intent to apply the spousal joint interest position in Section 2(a)(51)(A)(i) to Rule 3c-5. Thus, we would not recommend that the Commission take any enforcement action under Section 7 of the Investment Company Act if a knowledgeable employee and his or her spouse who is not a knowledgeable employee (or a qualified purchaser) invest jointly in a Section 3(c)(7) Fund.

Our positions, however, do not extend to joint interests held by knowledgeable employees and their dependents. The Commission's position with respect to determining the number of beneficial owners of securities issued by a Section 3(c)(1) Fund only pertains to securities jointly owned by both spouses. In addition, under Section 2(a)(51)(A)(i), dependents of a qualified purchaser who are not themselves qualified purchasers may not hold a joint interest in a Section 3(c)(7) Fund with the qualified purchaser.

(ii) We also believe that, consistent with the intent of Section 2(a)(51)(A)(iii) and Rule 3c-5, a family company trust or a similar estate planning vehicle, for which the knowledgeable employee is both responsible for investment decisions and the source of the funds invested, may be able to invest in securities issued by any Section 3(c)(1) Fund or any Section 3(c)(7) Fund in which the knowledgeable employee is eligible to invest individually. Furthermore, we believe that such an investment would be deemed to have been made by the knowledgeable employee.

Section 2(a)(51)(A)(iii) generally defines as a qualified purchaser any trust that is not covered by clause (ii),[27] was not formed for the specific purpose of acquiring the securities

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[26]*Id.*, at nn.67-68 and accompanying text.

[27]We assume that the entity that you describe would not be a qualified purchaser under Section 2(a)(51)(A)(ii). Any family company that meets the definition of qualified purchaser in Section 2(a)(51)(A)(ii) also may purchase securities issued by a Section 3(c)(7) Fund, regardless of whether the person who manages the trust's investments or is the source of the trust's assets is a knowledgeable employee of the Fund or a qualified purchaser, provided that the requirements of that section are met.

offered and whose the trustee and settlor are qualified purchasers. We believe that Congress required that both the trustee and the settlor of the trust be qualified purchasers because of its belief that both the person contributing assets to the trust, and the person authorized to make investment decisions with respect to those assets, should have the requisite financial sophistication to understand and evaluate the risks associated with purchasing securities of an investment pool that is not regulated under the Investment Company Act.[28] Rule 3c-5 is premised on the belief that certain persons, because of their financial knowledge and their relationship with a Section 3(c)(1) Fund or a Section 3(c)(7) Fund, have the financial sophistication to understand the risks associated with purchasing securities of that Fund.

We believe that it would be consistent with Congress's intent to permit a family company trust or similar estate planning entity to invest in securities issued by a Section 3(c)(7) Fund if a knowledgeable employee of that Fund is responsible for the investment decisions and is the source of the funds invested. Therefore, we would not recommend that the Commission take any enforcement action under Section 7 of the Investment Company Act if a family company trust or similar estate planning entity is treated as a knowledgeable employee of a Section 3(c)(7) Fund for purposes of investing in securities issued by that Fund, provided that a knowledgeable employee of the Fund is responsible for investment decisions and is the source of the funds invested. Similarly, given the intent of Rule 3c-5, we would not recommend that the Commission take any enforcement action under Section 7 of the Investment Company Act if a family company trust or similar estate planning entity is treated as a knowledgeable employee of a Section 3(c)(1) Fund for purposes of investing in securities issued by that Fund, provided that a knowledgeable employee of the Fund is responsible for investment decisions and is the source of the funds invested.

As we discussed in our Answer to Question A.4.(i), we take the position that a knowledgeable employee of a Section 3(c)(1) Fund or a Section 3(c)(7) Fund may invest jointly in that Fund with his or her spouse, and that such an investment would be deemed to have been made by the knowledgeable employee. Accordingly, our positions, discussed immediately above, with respect to a family company trust or similar estate planning entity being treated as a knowledgeable employee, would not be affected if the source of the funds invested is property that was jointly owned by the knowledgeable employee and his or her spouse.

Question 5: Does an investor who acquired securities issued by a Section 3(c)(1) Fund before the effective date of the 1996 Act count toward the 100-owner limit if he or she would have been considered a knowledgeable employee at the time of acquisition, but is not one on the effective date of the 1996 Act (due, for example, to termination of employment)?

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[28] *See* Meadowbrook Real Estate Fund (pub. avail. Aug. 26, 1998) ("Meadowbrook Letter").

Answer: No. Rule 3c-5(b)(1) states, in part, that for purposes of determining the number of beneficial owners of a Section 3(c)(1) Fund, there shall be excluded securities beneficially owned by a person who at the time that the securities were acquired was a knowledgeable employee of the Fund. This provision is based on the belief that persons who are financially knowledgeable and sophisticated with respect to a Section 3(c)(1) Fund at the time that they make decisions to purchase securities issued by that Fund should not be counted toward that section's 100-owner limit. We therefore believe that, if a person was a knowledgeable employee at the time that the securities were purchased, the person is not counted toward the 100-owner limit, regardless of whether the purchase occurred prior to the adoption of the rule or the person ceased to be a knowledgeable employee subsequent to the purchase.

Questions 6 and 7: Does an investor who acquired securities issued by a Section 3(c)(1) Fund before the effective date of the 1996 Act count toward the 100-owner limit if he or she would not have been deemed a knowledgeable employee at the time of acquisition but was a knowledgeable employee on the effective date? If an investor who does not qualify as a knowledgeable employee invests in a Section 3(c)(1) Fund, may the Fund cease to count such a person as a beneficial owner once he or she satisfies the knowledgeable employee test?

Answer: The staff has stated that Rule 3c-5 is premised on the requirements that a knowledgeable employee of a Section 3(c)(1) Fund be financially sophisticated and knowledgeable and have a business relationship with the Fund such that the employee would have access to information about the Fund.[29] We believe that it would be consistent with the rule to treat a person as having been a knowledgeable employee at the time of any investments in a Section 3(c)(1) Fund if that person subsequently became a knowledgeable employee of the Fund. We therefore would not recommend enforcement action to the Commission under Section 7 of the Investment Company Act if a person who became a knowledgeable employee of a Section 3(c)(1) Fund after purchasing securities issued by that Fund were treated as having been a knowledgeable employee of the Fund at the time of the prior purchases.[30]

Question 8: May a knowledgeable employee invest in a Section 3(c)(1) Fund or a Section 3(c)(7) Fund through an IRA, trust or other entity for which he or she is responsible for investment decisions and where the source of funds invested in the securities issued by the

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[29]*See supra* Answers to Questions A.1., A.2., and A.3.

[30]Such a person would not be required to dispose of these securities (or be counted as beneficial owners for purposes of Section 3(c)(1)'s 100-owner limit) upon termination of employment. Adopting Release, *supra* note 5, at n.120.

Fund was individual property or property held jointly with the knowledgeable employee's spouse (without being counted toward the Fund's 100-owner limit or without being a qualified purchaser)?

Answer: When an entity that invests in securities issued by a Section 3(c)(1) Fund or a Section 3(c)(7) Fund is the "alter ego" of a knowledgeable employee (*i.e.*, the entity is wholly owned by the employee, the employee makes all of the decisions with respect to the entity's investments, and the investments are for the benefit of the employee), we would consider the investment to have been made by the employee for purposes of Rule 3c-5. In accordance with our spousal joint interest position discussed in our Answer to Question A.4.(i)., we also would consider such an entity to be an alter ego of the knowledgeable employee notwithstanding the fact that the entity was jointly owned with the employee's spouse and the employee and his or her spouse were joint beneficiaries of the investments. Thus, a knowledgeable employee may invest in a Section 3(c)(1) Fund or a Section 3(c)(7) Fund through an IRA or any other entity which may be considered to be the alter ego of the employee.[31]

As we discussed in our Answer to Question A.4.(ii)., under some circumstances we would not recommend that the Commission take any enforcement action under Section 7 of the Investment Company Act if an entity such as the one that you described in your question invested in securities issued by a Section 3(c)(1) Fund without the entity being counted toward the Fund's 100-owner limit. Similarly, we would not recommend that the Commission take any enforcement action under Section 7 of the Investment Company Act if such an entity invested in securities issued by a Section 3(c)(7) Fund even though the entity is not a qualified purchaser.

B. Individual Retirement Accounts

Question 1: If an existing Section 3(c)(1) Fund elects to convert to a Section 3(c)(7) Fund pursuant to the Grandfather Provision, may a grandfathered investor, who is not otherwise a qualified purchaser, and whose interest in a Section 3(c)(7) Fund is, and was, prior to conversion, held in such investor's individual name, make additional investments in the Fund (following its conversion to a Section 3(c)(7) Fund) through his or her IRA or the self-directed account of a retirement plan?

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[31] *Cf.* Adopting Release, *supra* note 5, at text following n.78 ("when an entity that holds investments is the 'alter ego' of a Prospective Qualified Purchaser (as in the case of an entity that is wholly-owned by a Prospective Qualified Purchaser who makes all the decisions with respect to such investments), it would be appropriate to attribute the investments held by such entity to the Prospective Qualified Purchaser.").

Answer: Yes. The Grandfather Provision was designed to enable a Section 3(c)(1) Fund that converts to a Section 3(c)(7) Fund to preserve its arrangements with its grandfathered investors. Furthermore, the Grandfather Provision does not prevent grandfathered investors from making additional investments in the Grandfathered Fund.[32] We take the position that, when an entity that invests in securities issued by a Grandfathered Fund is the alter ego of a grandfathered investor (*i.e.*, the entity is wholly owned by the grandfathered investor, the grandfathered investor makes all the decisions with respect to such investments, and the investments are for the benefit of the grandfathered investor), we would consider the acquisition to have been made by the grandfathered investor.[33] Thus, a grandfathered investor may continue to purchase securities in the Grandfathered Fund through an entity, such as an IRA or a self-directed account of a retirement plan, that is the alter ego of the investor.

Question 2: For purposes of determining whether or not an IRA or the self-directed account of a retirement plan is a qualified purchaser, may one look through the IRA or account to its creator?

Answer: When an entity, such as an IRA or self-directed account of a retirement plan, that acquires securities issued by a Section 3(c)(7) Fund is the alter ego of the investor, we would consider the acquisition to have been made by the investor. Thus, a qualified purchaser may invest in securities issued by a Section 3(c)(7) Fund through any IRA, self-directed account of a retirement plan, or other entity that is the investor's alter ego.[34]

C. Trusts

Question 1: Under Section 2(a)(51)(A)(iii), at what time is the status of each trustee and settlor determined -- at the time of a particular investment or at the formation of the trust? What is the effect on qualification if the settlor is dead?

Answer: Section 3(c)(7) is premised on Congress's belief that certain persons, at the time of making the investment decision, have the financial sophistication to understand and evaluate the risks associated with purchasing securities of an investment pool that is not regulated under the Act.[35] Accordingly, under Section 2(a)(51)(A)(iii), a trust is a qualified purchaser

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[32]*See id.*, at n.82.

[33]*See supra* note 31.

[34]*See id.*

[35]*See supra* note 2 and accompanying text.

if, among other things, its trustee (or other person authorized to make decisions with respect to the trust) is a qualified purchaser under clauses (i), (ii), or (iv) of Section 2(a)(51)(A). Congress intended that the trustee (or other person authorized to make decisions with respect to the trust) have the requisite financial sophistication at the time that the decision to invest is made. The staff therefore has taken the position that the time to determine the qualified purchaser status of the trustee who is responsible for investing the assets of the trust, and thus is the person responsible for understanding and evaluating the risks associated with each investment decision, is when the trustee makes the decision to acquire securities issued by a Section 3(c)(7) Fund.[36]

The staff also has taken the position that a settlor of a Section 2(a)(51)(A)(iii) trust must be a qualified purchaser at the time that the settlor contributed assets to the trust.[37] This position reflects Congress's intent that the person whose assets are at risk -- and not only the person making the investment decision -- should be able to appreciate the risks presented by an investment pool that is not subject to regulation under the Investment Company Act. It would be consistent with this intent to require that the settlor be a qualified purchaser (*i.e.*, financially sophisticated) at the time that the settlor makes the decision to contribute assets[38] to the trust.[39]

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[36]Meadowbrook Letter, *supra* note 28.

[37]To meet this requirement, the settlor would have to have been a qualified purchaser at least once when he or she contributed assets to the trust. Thus, a settlor who was a qualified purchaser at the time that he or she initially funded the trust, but was not a qualified purchaser when he or she made subsequent contributions, would still be considered a qualified purchaser for purposes of the settlor requirement. Similarly, a settlor who was not a qualified purchaser at the time that he or she initially funded the trust, but was a qualified purchaser when the settlor made other contributions, would meet the requirement. *Id.*, at n.18 and accompanying text.

[38]As we stated in the Meadowbrook Letter, however, we believe that there may be other situations in which a settlor would have, at the appropriate time, the requisite financial sophistication to appreciate the risks presented by a Section 3(c)(7) Fund, thereby satisfying the purpose of the settlor requirement. *Id.*, at n.21. The staff, however, has not yet been presented with any of these situations.

[39]We disagree with your analysis that a trust should be treated as a qualified purchaser under Section 2(a)(51)(A)(iii) solely because the settlor is deceased and the trustee is a qualified purchaser. By analogy, under Section 2(a)(51)(A)(iv), an investment manager who is a qualified purchaser -- even one who invests $25 million on a discretionary basis -- cannot invest a client's assets in a Section 3(c)(7) Fund unless the client also is a qualified purchaser. *See* Senate Report, *supra* note 2, at 10 ("An investment adviser managing private accounts would not be permitted to purchase interests in a qualified purchaser pool on behalf

Question 2: Section 2(a)(51)(A)(iii) of the Investment Company Act provides that a qualified purchaser includes any trust not covered by Section 2(a)(51)(A)(ii) of that Act and that was not formed for the specific purpose of acquiring the securities offered as to which "the trustee or other person authorized to make decisions with respect to the trust" is a qualified purchaser. Is it sufficient if only the trustee actually making the investment decision to acquire the securities at issue is a qualified purchaser?

Answer: As discussed previously, Section 3(c)(7) is premised on Congress's belief that financially sophisticated persons are able to assess the risks of investing in Section 3(c)(7) Funds, and therefore these persons do not need the protections of the Act.[40] We believe that if the trust has more than one trustee, only the trustee who is responsible for making investment decisions with respect to the trust, and therefore will be responsible for assessing the risks associated with investing in Section 3(c)(7) Funds, must be a qualified purchaser.

Question 3: If a trust that is not covered by Section 2(a)(51)(A)(ii) has less than $5 million in investments and not all of the trustees authorized to make investment decisions or settlors of the trust are qualified purchasers, may the trust still be deemed a qualified purchaser if all of the trust's beneficiaries are qualified purchasers? Should the use of a trust format, as opposed to a family company format (where a look-through would clearly be permissible), dictate whether a look-through to the beneficiaries is possible?

Answer: Under Rule 2a51-3(b), a company may be deemed to be a qualified purchaser if each beneficial owner of its securities is a qualified purchaser. You argue that, because Section 2(a)(8) of the Investment Company Act defines "company" to include a trust, Rule 2a51-3(b) should be interpreted to permit a trust to be deemed to be a qualified purchaser if all of its beneficiaries are qualified purchasers, even though none of the trust's settlors or trustees is a qualified purchaser.

We disagree. Under Section 2(a)(51)(A)(iii), a trust is a qualified purchaser if, among other things, its trustee (or other person authorized to make decisions with respect to the trust), and each settlor (or other person who has contributed assets to the trust), are qualified purchasers under clauses (i), (ii), or (iv) of Section 2(a)(51)(A). We believe that Congress required that both the trustee and the settlor of the trust be qualified purchasers because of its belief that both the person contributing assets to the trust, and the person authorized to make investment decisions with respect to those assets, should have the requisite financial sophistication to understand and evaluate the risks associated with purchasing securities of an investment pool that is not regulated under the Investment

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of a client unless that client is also a qualified purchaser.").

[40]*See supra* note 2 and accompanying text; *see also supra* Answer to Question C.1.

Company Act.[41] Your interpretation would permit a trust to invest in securities issued by a Section 3(c)(7) Fund, even though neither the person contributing assets to the trust nor the persons making investment decisions with respect to the trust's assets would be a qualified purchaser. We therefore believe that interpreting Rule 2a51-3(b) in the manner that you suggest would be inconsistent with Congress's intent in enacting Section 2(a)(51)(A)(iii).[42]

Question 4: Under Section 2(a)(51)(A)(ii) of the Investment Company Act, a qualified purchaser includes any company that owns not less than $5 million in investments and is owned by two or more related persons. For a trust to be a qualified purchaser under this definition, it must therefore be owned by two or more related persons. Who is considered to "own" a trust?

Answer: Section 2(a)(51)(A)(ii) is intended to permit "certain family investment vehicles -- family trusts and other types of companies --"[43] that are formed to facilitate estate planning[44] to invest in Section 3(c)(7) Funds. According to the legislative history, Congress intended that any company with $5 million in investments and "that is owned by an extended family" be treated as a qualified purchaser.[45] Congress did not, however, specifically address what it intended by the use of the term "owned" in the context of trusts.

We believe that Congress intended that all economic interests in a company that relies on Section 2(a)(51)(A)(ii) be held exclusively by persons who satisfy the family relationship requirements of that section.[46] The staff recently took the position that beneficiaries of certain trusts may be considered to be the "owners" of those trusts for purposes of Section

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[41]*See* Meadowbrook Letter, *supra* note 28.

[42]Some trusts that are not qualified purchasers, however, may nevertheless invest in securities issued by a Section 3(c)(7) Fund. *See, e.g., supra* Answers to Questions A.4.(ii)., A.8., and B.1. *See infra* Answer to Question C.5.

[43]Senate Report, *supra* note 2, at 10.

[44]*See The Securities Investment Promotion Act of 1996: Hearing on S. 1815 before the Senate Committee on Banking, Housing and Urban Affairs,* 104th Cong. 2d Sess. 41 (1996) (testimony of Arthur Levitt, Chairman, SEC).

[45]Senate Report, *supra* note 2, at 10.

[46]In this regard, we believe that a trust generally would be able to rely on that section only if all present or future, vested or contingent, economic interest in its assets are held exclusively by eligible family members. Meadowbrook Letter, *supra* note 28.

2(a)(51)(A)(ii). This position was based on the representation that the beneficiaries are the only persons who hold economic interests in the trusts.[47]

Question 5: May a grandfathered investor, who is not otherwise a qualified investor, (i) transfer his or her investment in the Grandfathered Fund to an IRA, trust, or other entity and (ii) make additional investments in the converted Section 3(c)(7) Fund through the IRA, trust or other entity?

Answer: (i) As discussed in our Answer to Question B.1., we take the position that when an entity that invests in securities issued by a Grandfathered Fund is the alter ego of a grandfathered investor, we would consider the investment to have been made by the grandfathered investor. Therefore, a grandfathered investor may transfer his or her investment in the Grandfathered Fund to any entity that is an alter ego of that investor, because the grandfathered investor effectively would be transferring the securities to himself or herself.

We also believe that it would be consistent with the intent of Rule 3c-6 if, when persons who acquire securities issued by a Grandfathered Fund from a grandfathered investor, the securities are treated as being owned by the grandfathered investor, provided that the other requirements of Rule 3c-6 are met.[48] Rule 3c-6 provides that beneficial ownership of securities issued by a Section 3(c)(7) Fund that are acquired from a qualified purchaser are treated under certain circumstances as being owned by the qualified purchaser. Rule 3c-6 does not, however, address the transfer by a grandfathered investor of securities issued by a Grandfathered Fund. Therefore, we would not recommend enforcement action to the Commission under Section 7 of the Investment Company Act if a grandfathered investor transfers his or her investments in the Grandfathered Fund to any person or entity and the

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[47]*Id.* In this letter, counsel represented that, while the trustee receives fees for services rendered, such fees do not represent an economic interest comparable to an ownership interest in the company.

[48]Rule 3c-6 applies when a Transferor transfers securities to (i) the estate of the Transferor; (ii) a Donee; or (iii) a company established by the Transferor exclusively for the benefit of (or owned exclusively by) the Transferor and/or a Donee or the estate of the Transferor. The rule defines the term "Donee" as a person who acquires a security of a Section 3(c)(1) Fund or a Section 3(c)(7) Fund (or a security or other interest in a company established by the Transferor exclusively for the benefit of (or owned exclusively by) the Transferor and/or a Donee or the estate of the Transferor) as a gift or bequest or pursuant to an agreement relating to a legal separation or divorce.

Transferee were not counted toward the 100-owner limit in the Grandfather Provision,[49] provided that the other requirements of Rule 3c-6 are satisfied.

(ii) As discussed in our Answer to Question B.1., a grandfathered investor may continue to purchase securities in the Grandfathered Fund through an entity, such as an IRA, that is the alter ego of the investor. As a general matter, however, we believe that a grandfathered investor, who is making the investment decisions with respect to the assets of a trust or other entity that is not the alter ego of the investor, may not invest that entity's assets in the Grandfathered Fund unless the entity itself is a qualified purchaser. We believe that this type of transaction may be considered to be a new arrangement between the grandfathered investor and the Fund, which would be inconsistent with the intent of the Grandfather Provision.[50]

D. Section 2(a)(51)(A)(iii) and Rule 2a51-3: "Formed for the Specific Purpose"

Question: When is an entity deemed to be formed for the specific purpose of acquiring securities in a Section 3(c)(7) Fund?

Answer: Section 2(a)(51)(A)(iii) specifies that a trust that is a qualified purchaser under that section must not have been formed "for the specific purpose of acquiring the securities offered." Rule 2a51-3(a) makes that condition applicable to any prospective qualified purchaser seeking to rely on Section 2(a)(51)(A)(ii) or (iv) unless each beneficial owner of the prospective qualified purchaser's securities is a qualified purchaser. The rule limits the possibility that a company will form an entity for the specific purpose of making an investment in a Section 3(c)(7) Fund available to investors that themselves are not qualified purchasers.[51] This conduct also may raise issues under Section 48(a) of the Investment Company Act, which prohibits an entity from doing indirectly what it is prohibited from

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[49]As discussed in the Background section, the Grandfather Provision states that the outstanding securities of a Grandfathered Fund may be beneficially owned by as many as 100 persons that are not qualified purchasers, provided that these persons acquired the securities of the Grandfathered Fund on or before September 1, 1996. The requirement that persons who are not qualified purchasers must have acquired the securities on or before September 1, 1996 is intended to define the persons who may be grandfathered investors (*i.e.*, those persons who held securities of the Section 3(c)(1) Fund prior to the enactment of the 1996 Act and who do not meet the definition of qualified purchaser). We interpret this requirement as not prohibiting a grandfathered investor from transferring his or her securities under certain conditions after the Section 3(c)(1) Fund has converted to a Section 3(c)(7) Fund.

[50]*See supra* Answer to Question B.1.

[51]Adopting Release, *supra* note 5, at n.112 and accompanying text.

doing directly, and gives the Commission the authority to "look-through" a transaction if it is a sham or conduit formed or operated for no purpose other than circumventing the requirements of the Act.[52]

You note that the staff has indicated that, if an entity is formed for the specific purpose of acquiring securities in a particular Section 3(c)(1) Fund, the owners of that entity may be counted in determining the number of beneficial owners of that Fund. You further note that the staff has taken the position that, in the Section 3(c)(1) context, the determination that an entity is formed for the specific purpose of investing in a Section 3(c)(1) Fund will depend upon an analysis of all of the surrounding facts and circumstances, and while the percentage of an entity's assets invested in the Section 3(c)(1) Fund is relevant, exceeding a specified percentage level, by itself, is not determinative.[53] You suggest that the staff apply this analysis in the context of entities investing in Section 3(c)(7) Funds.

We agree. The staff takes the position that any entity whose investors consist of non-qualified purchasers, that was formed or operated for the purpose of investing in a Section 3(c)(7) Fund, and that subsequently invests in such a Fund, may result in a violation of Section 48(a) and/or Section 7 of the Investment Company Act (because the entity would not be considered a qualified purchaser under Section 2(a)(51)(A) and thus the Fund could not rely on Section 3(c)(7)).[54] We agree that our analysis with respect to entities investing in a Section 3(c)(1) Fund also applies with respect to entities investing in a Section 3(c)(7) Fund. Thus, we believe that the determination that an entity is formed for the specific purpose of investing in a Section 3(c)(7) Fund will depend upon an analysis of all of the surrounding facts and circumstances, and while the percentage of an entity's assets invested in the Section 3(c)(7) Fund is relevant, exceeding a specified percentage level, by itself, is not determinative. Of course, any entity that is not formed for the purpose of investing in a Section 3(c)(7) Fund can invest in such a Fund only if the entity itself meets the definition of qualified purchaser under Section 2(a)(51)(A).

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[52]*See* Cornish & Carey (pub. avail. June 21, 1996).

[53]*Id.*

[54]While Section 2(a)(51)(A)(iii) and Rule 2a51-3 only seek to prevent entities from being "formed" for the purpose of circumventing the Investment Company Act, Section 48 applies both to entities that are formed *or operated* for the purpose of circumventing the Act. Thus, while an entity that is operated for the specific purpose of acquiring securities in a Section 3(c)(7) Fund may nevertheless still be considered a qualified purchaser under Section 2(a)(51)(A), that entity and the Fund may be in violation of Section 48(a).

E. Rule 3c-6: Involuntary Transfers

Question 1: Does the rule on involuntary transfers also include distributions from testamentary or inter vivos trusts or other entities?

Answer: Rule 3c-6 generally pertains to the transfer of securities issued by a Section 3(c)(1) Fund or a Section 3(c)(7) Fund that occurs pursuant to a gift, bequest, or an agreement relating to a legal separation or divorce. The issue raised by your question is whether distributions from testamentary or inter vivos trusts would be considered to be gifts or bequests for purposes of Rule 3c-6. Whether a distribution from a testamentary or inter vivos trust is governed by the rule depends on the particular facts and circumstances.

Question 2: May securities of a Section 3(c)(7) Fund be transferred to a person by gift if the Fund requires additional contributions of capital in the future and either (i) the Transferor agrees to pay the additional contributions as they become due or are called by the Fund and the Fund agrees not to enforce the obligation to pay the additional contributions against the Transferee or (ii) simultaneously with the gift, the Transferor provides sufficient assets to the Transferee to enable it to satisfy the additional contributions?

Answer: (i) In the Adopting Release, the Commission noted that Rule 3c-6 would not apply if a person acquires the securities issued by a Section 3(c)(1) Fund for consideration, and that any person that pays consideration for these securities must be counted toward the 100-owner limit of the Section 3(c)(1) Fund.[55] Similarly, we believe that Rule 3c-6 would not apply if a person acquires the securities issued by a Section 3(c)(7) Fund for consideration, and thus any person that pays consideration for these securities must be a qualified purchaser, a knowledgeable employee, or a grandfathered investor. We also believe that any obligation to pay for any additional contributions of capital may be a form of consideration, and thus Rule 3c-6 may not apply if a Transferor transfers securities issued by a Section 3(c)(7) Fund to a Transferee, but the Transferee is obligated to pay additional contributions as they become due or are called by the Fund. We believe that the requirement that additional contributions be made to the Fund after the Transferor transfers securities to the Transferee would not prevent the Fund from relying on Rule 3c-6, however, if the Transferor agrees to pay the additional contributions as they become due or are called by the Fund and the Fund agrees not to enforce the obligation to pay the additional contributions against the Transferee.

(ii) As discussed in our Answer to Question E.2.(i)., we believe that any obligation to pay for any additional contributions of capital may be a form of consideration, and thus Rule 3c-6 may not apply if a Transferor transfers securities issued by a Section 3(c)(7) Fund to a Transferee and the Transferee is obligated to pay additional contributions as they become

[55] *See* Adopting Release, *supra* note 5, at n.132.

due or are called by the Fund. Therefore, as a general matter, Rule 3c-6 does not apply if the Transferee is under any obligation to pay additional contributions, even if the Transferor provides the Transferee with sufficient assets to pay those contributions.

Furthermore, Rule 3c-6 as a general matter does not apply if a Transferor transfers assets to a Transferee who is not a qualified purchaser with the intention that the Transferee use the assets to purchase securities issued by a Section 3(c)(7) Fund, even if the assets are a gift. Nonetheless, we believe that it may be consistent with Rule 3c-6, and we would not recommend any enforcement action to the Commission under Section 7 of the Investment Company Act, if a Transferor transferred sufficient assets to enable the Transferee to satisfy any future capital contributions, and the Transferee used the assets to purchase securities issued by the Fund, if there were appropriate procedures in place reasonably designed to ensure that the assets would in fact be available and be of a sufficient amount for the contributions to be paid, and the Transferee is not under any obligation to pay the contributions.

Question 3: May a company established by a qualified purchaser exclusively for the benefit of (or owned exclusively by) the qualified purchaser and his or her estate or donees receive securities of a Section 3(c)(7) Fund by gift if the Fund requires additional contributions of capital in the future and the contributions are paid out of assets previously held by the company so long as such assets derived exclusively from the qualified purchaser?

Answer: As we discussed in our Answer to Question E.2.(ii)., in accordance with the terms of Rule 3c-6, a Transferor may transfer securities issued by a Section 3(c)(7) Fund, together with sufficient assets to enable the Transferee to satisfy future additional contributions required by the Fund, if there were appropriate procedures in place reasonably designed to ensure (i) that the assets would be used only to pay the contributions, and (ii) that the assets would in fact be available and be of a sufficient amount for the contributions to be paid. In addition, the Transferee may not be under any obligation to pay the contributions. Therefore, a Transferor may transfer by gift securities issued by a Section 3(c)(7) Fund to a company, such as the one that you describe in your question (and which is a permissible Transferee under Rule 3c-6(b)(3)), and future capital contributions required by the Fund may be paid out of assets previously held by the company that were derived exclusively from the Transferor, provided that the company had in place the appropriate procedures, described above, and that the company was under no obligation to pay the contributions.

Question 4: Should an interest owned by a company in a Section 3(c)(7) Fund that is received by the holders of the company, either as a distribution or in dissolution of the company, be considered the equivalent of a gift to such holders so long as the company was not specifically formed for the purpose of making the investment in question?

Answer: Rule 3c-6 would not be available for a distribution or a dissolution by a company because none of the company's holders who would receive the securities would be "(1) the estate of the Transferor; (2) a Donee; or (3) a company established by the Transferor exclusively for the benefit or (or owned exclusively by) the Transferor [and/or a Donee or the estate of the Transferor]," as required by Rule 3c-6(b).[56] Section 3(c)(7)(A) provides, in part, however, that securities issued by a Section 3(c)(7) Fund that are owned by persons who received them from a qualified purchaser as a gift or bequest, or when the transfer was caused by legal separation, divorce, death, *or other involuntary event*, will be deemed to be owned by a qualified purchaser, subject to such rules as the Commission may prescribe. The Commission has stated that Rule 3c-6 does not necessarily provide an exclusive list of involuntary events for purposes of Section 3(c)(7).[57] Whether distributions or dissolutions by a company would be considered to be "involuntary events" for purposes of Section 3(c)(7)(A) would depend on the particular facts and circumstances.[58]

F. Effect of Section 3(c)(7) Funds on Rule 144A Securities

Question: Would the Commission agree that a modified CUSIP number would be sufficient to comply with Section 3(c)(7) as in the case of Rule 144A?

Answer: Section 3(c)(7) generally requires holders of securities issued by a Section 3(c)(7) Fund to be qualified purchasers. Rule 2a51-1(h) generally defines the term "qualified purchaser" to mean any person that meets the definition of qualified purchaser in Section 2(a)(51)(A) and the rules thereunder, or that the Section 3(c)(7) Fund or a person acting on its behalf (each a "Relying Person") reasonably believes meets the definition. Rule 2a51-1(g)(1) generally provides that if a person seeking to purchase a security of a Section 3(c)(7) Fund is, or the Fund or other Relying Person reasonably believes is, a qualified institutional

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[56]*See supra* note 48.

[57]Adopting Release, *supra* note 5, at n.133.

[58]Section 3(c)(1)(B), which was enacted in 1980, contains a similar provision with respect to the involuntary transfers of securities of a Section 3(c)(1) Fund. *See supra* note 9. The staff previously issued several letters regarding this section, and counsel seeking to determine whether a transfer of securities of a Section 3(c)(7) Fund would be considered involuntary for purposes of Section 3(c)(7)(A) may wish to review these letters. *See, e.g.,* Trivest Special Situations Fund 1985 L.P. (July 13, 1989) (transfer of partnership interests to participants of a pension plan caused by the termination of the plan is not within the intent of Section 3(c)(1)(B) because the pension plan was voluntarily terminated when it was no longer economically advantageous to maintain it).

buyer as defined in Rule 144A ("QIB") under the Securities Act of 1933,[59] with the exception of self-directed employee benefit plans and certain dealers, that person is deemed to be a qualified purchaser ("QP-QIB").

You argue that it should not be necessary under Rule 2a51-1(g)(1) for the Fund or other Relying Person to form a reasonable belief that buyers are QP-QIBs. You state that, in the trading market for securities offered under Rule 144A ("144A Market"), it is the seller of the securities that determines that status of the purchaser, and not the issuer or other Relying Person. You therefore believe that the reasonable belief requirement should be deemed to have been satisfied if the seller of the securities has a reasonable belief that the purchaser is a QP-QIB on the basis of an established procedure for making this determination.

You further believe that one such procedure that would permit a seller to form the requisite reasonable belief would be the use of lists of securities maintained by dealers who participate in the 144A Market. You note that the CUSIP number of securities on these lists that can be purchased only by QIBs ("Rule 144A Securities") includes a special designation. You propose that a special designation be created for securities issued by Section 3(c)(7) Funds that would indicate that they can be purchased only by QP-QIBs. As an alternative, you propose that securities issued by Section 3(c)(7) Funds would be accepted for trading in the 144A Market only in large blocks, thus assuring the large size of the holders.

You also argue that, for purposes of Rule 2a51-1(h), a Section 3(c)(7) Fund should be able to form the requisite reasonable belief on the basis of deemed representations and warranties made by purchasers of the Fund's securities in the 144A Market that such purchasers are QP-QIBs and that any securities held by a purchaser who is not a QP-QIB must be divested. You state that the Fund's offering materials generally provide that there will be reliance on these representations and warranties. You argue that "most" participants in the 144A Market have at least $25 million under management and therefore would be qualified purchasers under Section 2(a)(51)(A)(iv), and that it is "doubtful" that there are many QIBs that are not also QP-QIBs.

We believe that a reasonable belief formed by a person other than the Fund or other Relying Person would satisfy neither the letter nor spirit of Rule 2a51-1. A Fund or other Relying Person may be able to develop procedures for resales in the 144A Market that, if followed, would be sufficient to form the requisite reasonable belief under Rule 2a51-1.[60]

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[59]Rule 144A sets forth a non-exclusive safe harbor from the registration requirements of Section 5 of the Securities Act for the resale of restricted securities to specified institutions by persons other than the issuer of such securities.

[60]A Relying Person might include, for example, a participant of the Depository Trust Company, provided that the participant is acting on the Fund's behalf.

We generally believe that any procedures developed for resales in the 144A Market for purposes of Rule 2a51-1 must be designed to provide a means by which the Fund or other Relying Person can make a reasonable determination that all of the purchasers of the Fund's securities were qualified purchasers at the time that they acquired the securities. While we agree that the procedures you propose could be components of reasonable compliance procedures, whether a particular set of procedures would be sufficient for a Fund or other Relying Person to form the requisite reasonable belief depends on the facts and circumstances.[61] As a result, the staff, as a matter of policy, will not respond to requests to assess whether any particular set of procedures could form the basis of a reasonable belief under Rule 2a51-1.

G. Timing of Qualified Purchaser Determination

Question: Does the Section 3(c)(7) Fund need to make a new determination of qualified purchaser status for an investor each time the investor elects to reinvest its earnings of the Fund?

Answer: No. Section 3(c)(7) excludes from the definition of investment company any issuer whose outstanding securities are owned by persons who, at the time of acquisition of the securities, are qualified purchasers, and which is not making or proposing to make a public offering of its securities. Consistent with prior staff interpretations of Section 3(c)(1),[62] the staff does not interpret Section 3(c)(7) as requiring the status of a person as a qualified purchaser to be reaffirmed in connection with the crediting of a Section 3(c)(7) Fund's earnings to an investor's account. Under some circumstances, however, a reinvestment of

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[61]The Division of Corporation Finance has advised us that the Division is not expressing any view on whether the procedures outlined in your letter satisfy the requirements of Rule 144A. Persons reselling securities in reliance on Rule 144A must reasonably believe that any offeree or purchaser is a QIB. Rule 144A provides non-exclusive methods for determining whether an offeree or purchaser is a QIB. The Division of Corporation Finance has given guidance in this area as well. *See, e.g.,* Commscan (pub. avail. Feb. 3, 1999).

[62]Weiss Global Limited Partnership (pub. avail. Nov. 1, 1990)(staff took position that the acquisition of securities would not occur, for purposes of the pre-amended Look Through Provision of Section 3(c)(1), when a limited partner's partnership interests increased due to (i) the crediting of partnership earnings to capital accounts or the effect of their distribution to other limited partners, or (ii) redemptions of partnership interests by the partnership).

dividends may be considered to be a public offering of securities, which would preclude a fund from relying on Section 3(c)(7).[63]

H. Short-Term Paper

Question: May holders of short-term paper issued by a Section 3(c)(7) Fund be excluded from having to meet the qualified purchaser standard in order to invest in the Fund?

Answer: No. Unlike Section 3(c)(1), Section 3(c)(7) does not specifically exclude short-term paper holders from its requirements.

I. Jointly Held Investments

Question 1: If a husband and wife are separate limited partners of a Section 3(c)(1) Fund, should they be counted as one or two beneficial owners?

Answer: If the husband and wife each owns securities of a Section 3(c)(1) Fund in his or her own name, then the Fund should count the husband and wife as two beneficial owners. If the securities are jointly owned by the husband and wife, then they should be counted as one beneficial owner.[64]

Question 2: If a husband and wife jointly own an entity that invests in a Section 3(c)(1) Fund, should that entity be counted as one beneficial owner even if the entity would be subject to a "look-through" because it owned more than 10% of the voting securities of the Section 3(c)(1) Fund or was formed for the purpose of investing in the Section 3(c)(1) Fund?

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[63]Section 3(c)(7)'s limitation on public offerings has been interpreted to permit offerings that comply with Section 4(2) of the Securities Act. *See* Adopting Release, *supra* note 5, at n.5. A reinvestment of earnings in securities may be considered to be a sale of securities for purposes of the Securities Act, and these securities may be subject to the registration provisions of that Act, absent an exemption from those provisions, such as that provided by Section 4(2). *See, e.g.*, Securities Act Release No. 929 (Jul. 29, 1936), 11 FR 10957 (1936); Investment Company Act Release No. 6480 (May 10, 1971) 36 FR 9627 (May 1971).

[64]Adopting Release, *supra* note 5, at n.69.

Answer: The entity would be counted as one beneficial owner if the entity's only shareholders are the husband and wife whose interests are jointly owned, regardless of whether the entity was formed for the specific purpose of investing in the Section 3(c)(1) Fund.[65]

J. Conversion to Section 3(c)(7) Fund

Question: If a Section 3(c)(1) Fund that is a limited partnership converts its status to a Section 3(c)(7) Fund, and that Fund subsequently converts from a limited partnership to a limited liability company (with appropriate partner consent as required by state law and the Fund's partnership agreement), will the Fund be able to continue to include its grandfathered investors?

Answer: A Section 3(c)(7) Fund that seeks to convert from a limited partnership to a limited liability company would be required to exchange the limited partnership interests held by its shareholders with securities issued by the limited liability company. If this exchange were deemed to be an "acquisition" for purposes of Section 3(c)(7), the grandfathered investors would have to be qualified purchasers in order to receive the new securities. We believe, however, that the receipt of new securities resulting from a change in legal form from a limited partnership to a limited liability company would not be such an acquisition, provided that (i) the change in legal form does not result in any material change in the interests of the grandfathered investors of the Fund, and (ii) the limited liability company will represent in all substantial respects the same business and enterprise as that of the limited partnership. Our position is consistent with our views with respect to the conditions under which a registered investment company may reorganize to change its legal form without the new entity either filing a new registration statement or registering its securities.[66]

Rochelle Kauffman Plesset
Rochelle Kauffman Plesset
Senior Counsel

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[65] *Id.*

[66] *See, e.g.*, CIGNA Aggressive Growth Fund (pub. avail. Feb. 15, 1985); Massachusetts Financial Development Fund, Inc. (pub. avail. Jan. 10, 1985); Institutional Liquid Assets, Inc. (pub. avail. May 28, 1978); Kemper Municipal Bond Fund, Inc. (pub. avail. Dec. 22, 1976).

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Re: Interpretive Issues Regarding New Rules For Private Investment Companies Under the Investment Company Act of 1940 (the "Act")

Gentlemen:

This letter is submitted by the Subcommittee on Private Investment Entities (the "Subcommittee") of the Federal Regulation of Securities Committee (the "Committee"), Section of Business Law (the "Section") of the American Bar Association with respect to the provisions of the National Securities Markets Improvement Act of 1996 (the "1996 Act") relating to private investment companies and the final rules adopted by the Securities and Exchange Commission (the "Commission") to implement such provisions (Rel. No. 1C-22597) (the "Rules").

We believe that the Rules have on an overall basis been effective and useful. In short, the experience with the Rules has been favorable. There are, however, certain issues which require interpretation or clarification. We have obtained from members of the Subcommittee and others a list of those issues and recommendations as to their resolution. We hope that this may be of assistance to the Staff. We request that the Staff issue interpretive guidance, in question and answer format or otherwise, which deals with these issues and others of which the Staff may be aware.[1]

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1. A draft of this letter has been circulated for comment among members of the Subcommittee and certain other persons.
(continued...)

A. Knowledgeable Employees

The issues that have arisen under the Rules frequently involve "knowledgeable employees." Rule 3c-5 permits "knowledgeable employees" of a private investment company and certain of its affiliates to acquire securities issued by the fund without being counted as beneficial owners for purposes of Section 3(c)(1) and without satisfying the qualified purchaser definition under Section 3(c)(7). Knowledgeable employees include executive officers, directors, trustees, general partners and advisory board members of the Section 3(c)(1) fund or Section 3(c)(7) fund (a "Covered Company") or an affiliated person of the Covered Company that manages the investment activities of the fund ("Affiliated Management Person") and other employees of the Covered Company or its Affiliated Management Person who, in connection with their regular functions or duties, participate in the investment activities of the fund or other investment companies managed by the fund's Affiliated Management Person, provided that such employee has been performing such functions or duties for the fund or its Affiliated Management Person or substantially similar functions or duties for another person for at least 12 months. Employees performing solely clerical, secretarial or administrative functions with regard to a fund are not deemed knowledgeable employees.

1. Issue: May certain marketing and investor relations professionals, research analysts, brokers and traders, attorneys, financial, compliance, operational and accounting officers of a Covered Company or an Affiliated Management Person who are non-executive employees of the Covered Company or Affiliated Management Person qualify as knowledgeable employees?

It is our understanding that the Staff does not view the requirement that employees "participate in the

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1. (...continued)
This letter represents the consensus view of the members of the Subcommittee and others who have submitted comments. It does not necessarily reflect the views of all who have reviewed it nor does it reflect the view of the American Bar Association, the Section or the Committee.

investment activities" of the fund as limiting the exception to portfolio managers or others who are directly involved, on a regular basis, with a fund's investment decision-making process. As a result of the information other employees may receive in the course of their regular functions or duties, the nature of their responsibilities for the fund and their evaluative abilities, certain other non-executive employees may be close enough to the investment decision-making function to be viewed as participants in that process. As a result, they may possess a sophisticated knowledge and understanding of the investment objectives, risks and operations of one or more funds and related investment companies offered by their employers. We believe, for example, that the definition of knowledgeable employees should be interpreted to include the following persons who meet such criteria: (i) marketing and investor relations professionals who must explain potential and actual portfolio investments of a fund and the investment decision-making process and strategy being followed to clients and prospective investors and who, from time to time, interface among the fund, the portfolio managers and the fund's clients; (ii) research analysts who investigate the potential investments for the fund; (iii) attorneys who, as part of their duties, provide advice with respect to, or who participate in, the preparation of offering documents, and the negotiation of related agreements and who also are familiar with investment company management issues and respond to questions or give advice concerning ongoing fund investments, operations and compliance matters; (iv) brokers and traders of a broker-dealer related to the Covered Company or the Affiliated Management Person who are Series 7 registered; and (v) financial, compliance, operational and accounting officers of a fund who have management responsibilities for compliance, accounting and auditing functions of funds or their Management Affiliates.[2]

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2. As noted below in the discussion relating to issue number 3, investment management firms are organized in different forms for a variety of business reasons so that employees of entities related to the Covered Company or an Affiliated Management Person (rather than employees of the Covered Company or an Affiliated Management Person) often perform certain of these functions. For example, a marketing professional may be a broker for a brokerage firm (continued...)

2. Issue: May an employee who manages a fund that is not defined as an investment company under the Act pursuant to an exception other than Section 3(c)(1) or Section 3(c)(7) be eligible for knowledgeable employee status?

Under Rule 3c-5(a)(1), the term Affiliated Management Person means an affiliated person that manages the investment activities of a Section 3(c)(1) fund, a Section 3(c)(7) fund or an investment company. There does not appear to be any basis for distinguishing among a manager of a private investment company that is not defined as an investment company under Section 3(c)(1) or Section 3(c)(7) of the Act, a manager of a fund that is not defined as an investment company under another provision of the Act (e.g., commingled trusts excepted under Sections 3(c)(3) or 3(c)(11), or foreign or offshore investment companies excepted from registration under Section 6 of the Act) and a manager who manages only separately managed accounts (e.g., not a fund). They may each have the same investment objectives and responsibilities and perform similar functions and should be treated similarly. Non-executive employees (of the type described in our recommendation to issue number 1 above) of a fund not defined as an investment company under a provision of the Act other than Section 3(c)(1) or Section 3(c)(7) or a separately managed account should also be eligible for knowledgeable employee status.

3. Issue: Investment management complexes often establish, for various business reasons, a number of related entities that are involved in investment activities. May the definition of an "Affiliated Management Person" of a Covered Company include each affiliated entity of a Covered Person (regardless of corporate structure) that participates in the

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2. (...continued)
under common control with the Affiliated Management Person. We believe employees of related entities under common control should qualify as knowledgeable employees if they meet the functional criteria, regardless of whether they are technically employed by the Covered Company or the Affiliated Management Person.

investment activities of the investment management company?

The definition of an "Affiliated Management Person" of a Covered Company should include each related entity of a Covered Person that participates in the investment activities of the investment management company. Such an interpretation would provide consistency in the treatment of employees, irrespective of whether the investment management firm chooses to carry on all of its investment advisory businesses through separate operating divisions of a single legal entity or by dividing such business among related entities. Section 209(d)(3) of the 1996 Act seems to contemplate such an interpretation as it refers to "knowledgeable employees of . . . an affiliated person . . . ", in a manner that may encompass brother-sister entities. Moreover, such an interpretation is completely consistent with the Staff's long-standing practice of not making significant regulatory distinctions depend on whether a single fund complex operates through multiple divisions or multiple controlled entities.

4. Issue: If a knowledgeable employee invests in a Section 3(c)(1) fund or Section 3(c)(7) fund (i) jointly with a spouse and/or other dependents or (ii) through a family company, trust or other similar estate planning vehicle for which the knowledgeable employee is responsible for investment decisions and the source of the funds invested is individual property or property held jointly with the spouse, will such investment be deemed to have been made by the knowledgeable employee?

Section 2(a)(51)(A)(i) of the Act defines qualified purchaser as "any natural person (including any person who holds a joint, community property or other similar shared ownership interest in an issuer that is excepted under Section 3(c)(7) with that person's qualified purchaser spouse) who owns not less than $5,000,000 in investments." Rule 3c-5 permits knowledgeable employees to invest in a Section 3(c)(7) fund even though they do not meet the definition of qualified purchaser. We believe it would be consistent with the purposes of the Rules to permit a knowledgeable employee to invest in a Section 3(c)(7) fund

with his or her spouse through a joint, community property or other similar shared ownership interest or through family-owned or estate planning entities when the knowledgeable employee, alone or with his or her spouse, is the source of the investment funds and the knowledgeable employee, alone or with his or her spouse, directs the investment.

Rule 3c-5 also permits knowledgeable employees to invest in a Section 3(c)(1) fund without being counted for purposes of Section 3(c)(1)'s 100-investor limit. Consistent with the approach described above, we believe that a knowledgeable employee should also be permitted to invest in a Section 3(c)(1) fund with his or her spouse or through family-owned or estate planning entities when the knowledgeable employee, alone or with his or her spouse, is the source of the investment funds and the knowledgeable employee, alone or with his or her spouse, directs the investment without being counted as a beneficial owner. This would also be consistent with the Commission's current view that securities of a Section 3(c)(1) fund jointly owned by both spouses should be considered to be owned by one beneficial owner. (<u>See</u> footnote 69 of Rel. No. IC-22597.)

* * *

Rule 3c-5(b)(1) requires that a person be a knowledgeable employee at the time such person acquires securities in the fund. This means, for example, that an investor who (i) acquired securities in a Section 3(c)(1) fund before the effective date of the 1996 Act provisions relating to private investment companies (the "Effective Date") and would have been considered a knowledgeable employee at the time of acquisition (but had been counted as a beneficial owner for purposes of the 100-person limitation because the knowledgeable employee exception did not yet exist) and (ii) was a knowledgeable employee on the Effective Date, should no longer count toward the 100-person limitation of Section 3(c)(1). Additionally, an investor who (iii) acquired securities before the Effective Date and would not have been considered a knowledgeable employee at the time of acquisition and (iv) was not a knowledgeable employee on the Effective Date, would continue to count toward the 100-person limitation. While these situations are straightforward in terms of their application, the following interpretive issues should be resolved.

5. Issue: Does an investor who acquired securities in a Section 3(c)(1) fund before the Effective Date count toward the 100-person limitation if he or she would have been considered a knowledgeable employee at the time of acquisition, but is not one on the Effective Date (due, for example, to termination of employment)?

The investor should no longer count toward the 100-person limitation because he or she was a knowledgeable employee at the time the securities were acquired. As provided in footnote 120 of Rel. No. IC-22597, such investor should not be counted simply because employment with the fund has terminated.

6. Issue: Does an investor who acquired securities in a Section 3(c)(1) fund before the Effective Date count toward the 100-person limitation if he or she would not have been deemed a knowledgeable employee at the time of acquisition but was a knowledgeable employee on the Effective Date?

The investor should not count toward the 100-person limitation because he or she was a knowledgeable employee at the time the Rules went into effect. The purpose of the Rules is to allow sponsors to raise additional capital without sacrificing investor protection, and there is no public interest served by counting an investor who on the Effective Date qualified as a knowledgeable employee.

7. Issue: If an investor who does not qualify as a knowledgeable employee invests in a Section 3(c)(1) fund, may the fund cease to count such person as a beneficial owner once he or she satisfies the knowledgeable employee test?

At the time the investor qualifies as a knowledgeable employee, either because he or she becomes a general partner, director or executive officer of the Covered Company or because such person has been engaged in the investment activities of the Covered Company or another person for at least 12 months, he or she should no longer

count toward the 100-person limitation. At such time, the standard is satisfied and the fund should be entitled to reevaluate such employee's status. This would not have any adverse impact on investor protection and would be consistent with the purpose of the Rules. If the fund were not entitled to reevaluate the employee's status, it could result in the employee-investor withdrawing from the fund and then reinvesting immediately so that such employee's securities are acquired at the time he or she was a knowledgeable employee. This does not seem to make sense and would create unnecessary burdens for the fund and the employees and overly emphasize form over substance.

8. Issue: May a knowledgeable employee invest in a Covered Company through an IRA, trust or other entity for which he or she is responsible for investment decisions and where the source of funds invested in the Covered Company was individual property or property held jointly with the knowledgeable employee's spouse (without being counted toward the fund's 100-person limit or without being a qualified purchaser)?

Under Rule 3c-5, a knowledgeable employee may invest in a private investment company without being counted as a beneficial owner for purposes of Section 3(c)(1) and without satisfying the qualified purchaser definition under Section 3(c)(7). Rule 3c-5 also allows certain transferees of a knowledgeable employee to acquire securities of (i) a Section 3(c)(1) fund without counting as a beneficial owner and (ii) a Section 3(c)(7) fund without the transferee satisfying the qualified purchaser or knowledgeable employee standard. It would be consistent with the purposes of the Rules to permit a knowledgeable employee to invest in such funds directly through an IRA, trust or other entity where he or she is the source of the investment funds and directs the investment. Moreover, because a spouse who is not a qualified purchaser may hold a joint interest in a Section 3(c)(7) fund with such person's qualified purchaser spouse, the knowledgeable employee should, consistent with Section 2(a)(51)(A)(i) of the Act, be able to invest in such funds directly through a trust or other entity that is jointly owned with such knowledgeable employee's spouse and/or other dependents.

B. Individual Retirement Accounts

1. Issue: If an existing Section 3(c)(1) fund elects to convert to a Section 3(c)(7) fund pursuant to Section 3(c)(7)(B) of the Act, may a grandfathered investor, who is not otherwise a qualified purchaser, and whose interest in a 3(c)(7) fund is, and was, prior to conversion, held in such investor's individual name, make additional investments in the fund (following its conversion to a 3(c)(7) fund) through his or her IRA or the self-directed account of a retirement plan?

A grandfathered investor is permitted to make additional investments in the grandfathered fund. (See footnote 82 of Rel. No. IC-22597.) So long as the IRA beneficiary and the grandfathered investor are the same, allowing the investor to make additional investments through such investor's IRA or the self-directed account of a retirement plan would be consistent with footnote 82 of the Release.

2. Issue: For purposes of determining whether or not an IRA or the self-directed account of a retirement plan is a qualified purchaser, may one look through the IRA or account to its creator?

If the IRA or account beneficiary is a qualified purchaser who, alone or with others, determines how the money will be invested, then the IRA or account should also be deemed a qualified purchaser.

C. Trusts

Under the definition of qualified purchaser in Section 2(a)(51)(A) of the Act, trusts may qualify under either clause (ii), (iii) or (iv). Each clause focuses on a different standard: clause (ii) focuses on the value of the trust's investments and its ownership; clause (iii) looks to the qualification of the settlor and each trustee of the trust; and clause (iv) focuses only on the value of the trust's investments. These differing standards raise a number of interpretive issues.

1. Issue: Under Section 2(a)(51)(A)(iii), at what time is the status of each settlor and trustee determined – at the time of a particular investment or at the formation of the trust? What is the effect on qualification if the settlor is deceased?

Section 3(c)(7)(A) of the Act excepts any issuer whose outstanding securities are owned exclusively by persons who "at the time of acquisition of such securities" are qualified purchasers. The relevant time, therefore, to test the status of each settlor and trustee of the trust should be at the time of a particular investment. The Staff should clarify that if, at the time of an investment, a settlor is deceased, then such settlor will not be considered for purposes of determining whether the trust is a qualified purchaser. Instead, if the trustee authorized to make decisions with respect to the trust is a qualified purchaser, then the trust should be a qualified purchaser. If the Staff believes it is appropriate, it would be consistent with the statutory scheme to require that such a trust own not less than $5 million in investments in order to be a qualified purchaser.

2. Issue: Section 2(a)(51)(A)(iii) of the Act provides that a qualified purchaser includes any trust not covered by Section 2(a)(51)(A)(ii) of the Act and that was not formed for the specific purpose of acquiring the securities offered as to which "the trustee or other person authorized to make decisions with respect to the trust and each settlor or other person who has contributed assets to the trust" is a qualified purchaser. Is it sufficient if only the trustee actually making the investment decision to acquire the securities at issue is a qualified purchaser?

Under some trust agreements, there are trustees appointed with different authority (for example, a trustee may be appointed to have only administrative authority). It should not be necessary for a trustee who did not participate in a particular investment decision (and whose consent was not needed to make such investment) to be a qualified purchaser in order to qualify the trust.

3. Issue: If a trust that is not covered by Section 2(a)(51)(A)(ii) of the Act has less than $5,000,000 in investments and not all of the trustees authorized to make investment decisions or settlors of the trust are qualified purchasers, may the trust still be deemed a qualified purchaser if all of the trust's beneficiaries are qualified purchasers? Should the use of a trust format, as opposed to a family company format (where a look-through would clearly be permissible), dictate whether a look-through to the beneficiaries is possible?

Under Rule 2a51-3(b), a company may be deemed a qualified purchaser if each beneficial owner of its securities is a qualified purchaser. As Section 2(a)(8) of the Act defines "company" to include a trust, we believe this same look-through should be permitted to the beneficiaries of a trust.

4. Issue: Under Section 2(a)(51)(A)(ii) of the Act, a qualified purchaser includes any company that owns not less than $5 million in investments and is owned by two or more related persons. For a trust to be a qualified purchaser under this definition, it must therefore be owned by two or more related persons. Who is considered to "own" a trust?

If the beneficiaries of the trust were two or more of the related persons described in Section 2(a)(51)(A)(ii), and the trust owns not less than $5 million in investments, the trust should be deemed a qualified purchaser under that provision.

5. Issue: May a grandfathered investor, who is not otherwise a qualified purchaser (i) transfer his or her investment in the converted Section 3(c)(7) fund to an IRA, trust or other entity and (ii) make additional investments in the converted Section 3(c)(7) fund through the IRA, trust or other entity?

If the grandfathered investor is the settlor of the trust and the trustee who makes the particular

investment decision, or the one who is the source of the investment funds and who, alone or with others, directs the investments, then such transfer and additional investments should be permitted.

D. Formed for the Specific Purpose

Under the 1996 Act, in order for a trust to be a qualified purchaser, it must not have been formed "for the specific purpose of acquiring the securities offered." Rule 2a51-3(a) applies this condition to all entities that propose to become qualified purchasers unless each beneficial owner of an entity's securities is a qualified purchaser. This requirement limits the possibility that non-qualified investors could pool their investments in an entity that satisfied the qualified purchaser test. (See Rel. No. IC-22597 at 47.)

1. Issue: When is an entity deemed to be formed for the specific purpose of acquiring securities in a Section 3(c)(7) fund?

In the context of Section 3(c)(1), the Staff has indicated that if an entity is formed for the specific purpose of acquiring securities in a particular fund, the owners of that entity may be counted in determining the number of beneficial owners of that fund. In a series of no-action letters, the Staff conditioned relief to certain funds from such result on the representation, among other things, that the investing entity would not invest more than 40% of its committed capital in that particular Section 3(c)(1) fund.[3] In a 1996 no-action letter, the Staff noted that, because the 40% test is not a statutory requirement, it is not determinative of when the owners of an investing entity would need to be counted.[4] Rather, the determination that an entity is formed for the specific purpose under Section 3(c)(1) will depend upon an analysis of all of the surrounding facts and circumstances. It would

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3. See Risk Arbitrage Partners (1986), CMS Communications Fund L.P. (1987), Tyler Capital Fund, L.P./South Market Capital (1989), Handy Place Investment Partnership (1989) and Six Pack (1989).

4. See Cornish & Carey Commercial, Inc. (1996).

be helpful if the Staff clarifies its position on "formed for the specific purpose" in the context of Section 3(c)(7) funds. Will the Staff's position, as stated in Cornish & Carey, apply?

E. Involuntary Transfers

Under Rule 3c-6, beneficial ownership by any person who acquires securities of a Section 3(c)(1) fund from a person pursuant to an involuntary transfer (a gift, bequest or agreement relating to a legal separation or divorce) is deemed to be beneficial ownership by the person from whom such transfer was made. Securities of a Section 3(c)(7) fund that are owned by a person who received the securities from a qualified purchaser pursuant to an involuntary transfer are deemed to be owned by a qualified purchaser. In either type of fund, beneficial ownership by any person who acquires securities from a knowledgeable employee pursuant to an involuntary transfer is deemed to be beneficial ownership by a knowledgeable employee. Subsequent transfers by transferees that are in the form of a gift or bequest are also permitted without affecting the Section 3(c)(1) or Section 3(c)(7) exception.

1. Issue: Does the rule on involuntary transfers also include distributions from testamentary or inter vivos trusts or other entities?

So long as the decision to make the distribution is not made by the distributee, such distribution should be deemed an involuntary transfer permitted by Rule 3c-6.

2. Issue: May securities of a Section 3(c)(7) fund be transferred to a person by gift if the fund requires additional contributions of capital in the future and either (i) the transferor agrees to pay the additional contributions as they become due or are called by the fund and the fund agrees not to enforce the obligation to pay the additional contributions against the transferee or (ii) simultaneously with the gift, the transferor provides sufficient assets to the transferee to enable it to satisfy the additional contributions?

Investment funds frequently require their beneficial owners to make additional contributions of capital, either at specified intervals or as determined by the fund's general partner. We do not believe that the Staff intended that Rule 3c-6 be used to shift economic obligations to transferees who might not themselves be deemed qualified purchasers. If, however, a qualified purchaser makes a gift and agrees to pay additional contributions required by the fund (and the fund agrees to look solely to the transferor for payment), there would appear to be no policy reasons to disqualify such a transfer from the benefits of Rule 3c-6. The same result should follow if the qualified purchaser transferor provides sufficient assets to the transferee to satisfy the additional contributions.

3. Issue: May a company established by a qualified purchaser exclusively for the benefit of (or owned exclusively by) the qualified purchaser and his or her estate or donees receive securities of a Section 3(c)(7) fund by gift if the fund requires additional contributions of capital in the future and the contributions are paid out of assets previously held by the company so long as such assets derived exclusively from the qualified purchaser?

Under Rule 3c-6(b)(3), a company established by a qualified purchaser exclusively for the benefit of (or owned exclusively by) the qualified purchaser and his or her estate or donees may receive securities of a Section 3(c)(7) fund and be deemed a qualified purchaser even if the company does not otherwise satisfy the definition of qualified purchaser set forth in Sections 2(a)(51)(A)(ii) through (iv) of the Act. If the fund in which the company receives securities requires additional contributions of capital in the future, then so long as the assets that will be used to satisfy such contributions have been previously provided by the qualified purchaser transferor, there is no policy reason why such transfer of securities should not be permitted under Rule 3c-6.

4. Issue: Should an interest owned by a company in a Section 3(c)(7) fund that is received by the holders of the company, either as a

> distribution or in dissolution of the company, be considered the equivalent of a gift to such holders so long as the company was not specifically formed for the purpose of making the investment in question?

If the company was a qualified purchaser when it made the investment in the Section 3(c)(7) fund and was not formed for the specific purpose of making that particular investment, the company should be able to distribute its interest in the fund to the holders of interests in the company either from time to time or upon dissolution of the company without the holders being required to be qualified purchasers. Such a distribution should be deemed an involuntary transfer permitted by Rule 3c-6.

F. Effect of Section 3(c)(7) Funds on Rule 144A Securities and DTC Procedures

Rule 2a51-1(g)(1) provides that, with two exceptions, if a person seeking to purchase a security of a Section 3(c)(7) fund is, or is reasonably believed to be by a Relying Person (a Section 3(c)(7) fund or a person acting on its behalf), a qualified institutional buyer ("QIB"), as defined under Rule 144A promulgated under the Securities Act of 1933, then such person will be deemed to be a qualified purchaser. Reasonable belief may be established by inquiry directed to a prospective investor or a subsequent transferee before such person acquires securities of the fund. In the Rule 144A trading market, however, it is not a Relying Person who makes the determination that a buyer of securities is a QIB; it is the seller of the securities. Therefore, in order to give effect to Rule 2a51-1(g)(1), it is necessary to establish a different mechanism than the reasonable belief of a Relying Person. We believe that, by analogy to the Rule 144A market, a mechanism that would allow a qualified purchaser that is a QIB to have a reasonable belief that a person to whom it wishes to transfer securities of a Section 3(c)(7) fund is a QIB (subject to the two exceptions included in the Rule), should be sufficient.

Such a mechanism could be established by reference to lists maintained by dealers who, in the case of Rule 144A securities, know that the buyer of the security must be a QIB because the CUSIP number has an "R". Dealers police

themselves; they maintain a list of their customers which they believe are QIBs. This list would have to be slightly modified in the case of Section 3(c)(7) to take into account the different standards for dealers and trusts. The Commission has blessed these procedures as being in compliance with Rule 144A even though it is possible that such Rule 144A securities could potentially be held by non-QIBs. If these procedures are followed for qualified purchaser funds, the securities could be accepted into the DTC clearance system, thereby enhancing liquidity.

1. Issue: Would the Commission agree that a modified CUSIP number would be sufficient to comply with Section 3(c)(7) as in the case of Rule 144A?

If the CUSIP number in the case of Section 3(c)(7) securities contained a "QP" designation, a parallel procedure could be implemented. If the Commission orally concurs with the establishment of such a procedure, the relevant personnel in charge of the CUSIP system would need to be consulted to determine if such a change could be easily implemented, and who needs to request such a systems change. As an alternative, DTC acceptance of securities issued by Section 3(c)(7) funds might be confined to securities that were required to be traded in very large blocks, thus assuring the large size of the holders.

The foregoing issue is of increasing importance given the nature of the QIB market. A related issue is whether the Section 3(c)(7) fund may rely upon deemed representations and warranties of transferees as to qualified purchaser status. This issue arises both in domestic and offshore transactions (where there are issuances outside and into the United States in foreign securities). Customarily there is no certification from the transferee, but the offering materials specify that there will be reliance on the deemed representations and warranties of transferees. The offering materials specify that only QIBs may acquire the securities either initially or on resale. There is generally a provision requiring immediate divestiture by any holder that is an ineligible purchaser. We recommend that, for purposes of determining qualified purchaser status, a Relying Person may establish reasonable belief for purposes of Rule 2a51-1(h) by the use of this mechanism inasmuch as the QIB market is limited to

institutional buyers, most of whom would easily meet the $25 million in investments requirement under Section 2(a)(51)(A)(iv) and virtually all of whom can be identified from eligibility lists. It is doubtful that there are many institutions that are QIBs that are not also qualified purchasers. Given the nature of the institutional QIB market and the inclusion of procedures mandating divestiture by QIBs that are not qualified purchasers, we believe it would be appropriate for the Commission to clarify that the use of these or similar procedures would permit a Relying Person to meet the requirements of Rule 2a51-1(h), thereby promoting liquidity in the institutional QIB capital markets.

G. Timing of Qualified Purchaser Determination

Section 3(c)(7)(A) of the Act provides that the outstanding securities of a Section 3(c)(7) fund must be owned "exclusively by persons who, at the time of acquisition of such securities, are qualified purchasers." In Rel. No. IC-22597, the Commission stated that it believes this provision requires a new determination as to whether a person is a qualified purchaser each time the person acquires securities of a Section 3(c)(7) fund. The status of an investor as a qualified purchaser, however, does not need to be reaffirmed each time the investor makes additional capital contributions to a fund pursuant to a binding commitment that was made when the investor was determined to be a qualified purchaser.

1. Issue: Does the fund need to make a new determination of qualified purchaser status for an investor each time the investor elects to reinvest his or her earnings of the fund?

It should not be necessary to reaffirm qualified purchaser status when an investor reinvests earnings of the fund. Funds offer investors varying rights, including automatic reinvestment absent an annual earnings withdrawal decision. There is a distinction between reinvesting (or not withdrawing) earnings and making a new investment decision by contributing additional capital to a fund.

Such a finding would be consistent with Weiss, Global Ltd. Partnership (Nov. 1, 1990). In that letter, the Staff provided that, for purposes of the second 10% test

under the prior language of Section 3(c)(1)(A), the crediting of partnership earnings to capital accounts should not be treated as an acquisition of securities. The letter stated that a new acquisition of securities should only be triggered by purchases of securities with "new money" (as distinguished from earnings generated by the issuer). While the Weiss, Global letter dealt with the language of Section 3(c)(1) that has been eliminated in the 1996 Act, we believe that its reasoning should also be applicable to the first (and now only) 10% test of Section 3(c)(1) and also to Section 3(c)(7).

H. Short-Term Paper/Section 3(c)(7)

1. Issue: May holders of short-term paper issued by a Section 3(c)(7) fund be excluded from having to meet the qualified purchaser standard in order to invest in that fund?

For purposes of identifying the number of beneficial holders of a Section 3(c)(1) fund, holders of short-term paper issued by the fund are expressly excluded, presumably because their interests in the fund are sufficiently risk-differentiated from equity or long-term debt holders that they should be viewed more as ordinary creditors than as investors in the fund. The same exclusion should apply when identifying the class of investors that must be qualified purchasers for purposes of Section 3(c)(7).

I. Jointly-Held Investments

In footnote 69 of Rel. No. IC-22597, the Commission departed from an earlier Staff position and, consistent with Rule 2a51-1(g)(2), stated that, for purposes of determining the number of beneficial owners of a Section 3(c)(1) fund, securities of a fund jointly owned by two spouses should be considered to be owned by one beneficial owner. Previously, husbands and wives were counted as two beneficial owners.

1. Issue: If a husband and wife are separate limited partners in a Section 3(c)(1) fund, should they be counted as one or two beneficial owners?

If the limited partner interests are separately owned, then the husband and wife should be counted separately. If, however, the interest held by each spouse is jointly-owned property, then interests of the spouses should be considered to be owned by one beneficial owner.

2. Issue: If a husband and wife jointly own an entity (such as a limited partnership, a limited liability company or a trust) that invests in a Section 3(c)(1) fund, should that entity be counted as one beneficial owner even if the entity would be subject to a "look through" because it owned more than 10% of the voting securities of the Section 3(c)(1) fund or was formed for the purpose of investing in the particular Section 3(c)(1) fund?

So long as the interests in the entity are jointly owned, then the entity should count as one beneficial owner. This would be consistent with footnote 69 of Rel. No. IC-22597 and should apply regardless of whether the entity itself would be subject to a look-through.

J. <u>Conversion to a Section 3(c)(7) Fund</u>

1. Issue: If a Section 3(c)(1) fund that is a limited partnership converts its status to a fund that relies on the exclusion provided by Section 3(c)(7) and that fund subsequently converts from a limited partnership into a limited liability company (with appropriate limited partner consent as required under state law and the fund's limited partnership agreement), will the fund be allowed to continue to include persons who acquired interests in the limited partnership on or before September 1, 1996, even if such persons are not qualified purchasers?

We believe that such a fund should be allowed to continue to rely on Section 3(c)(7) even though it has changed its form from a limited partnership to a limited liability company; provided that the fund continues its business as previously conducted. Although this may be considered a technical change in the issuer, it is clearly a change of form and not of substance. The Commission has

consistently treated the new legislation relating to Sections 3(c)(1) and 3(c)(7) with an approach that does not elevate form over substance.

If a fund that maintains its organization as a limited partnership is able to continue to rely on Section 3(c)(7), we do not believe that any policy is furthered by not allowing that fund to rely on Section 3(c)(7) simply because it changes its form from a limited partnership to a limited liability company. Because the business of the fund will continue as previously conducted, the members who invested in the fund prior to September 1, 1996, are not afforded any additional protection by prohibiting reliance on Section 3(c)(7); state law and the limited partnership agreement govern the appropriate consent of the limited partners to such a transaction.

Limited liability companies are becoming more popular as vehicles for private investment companies. Furthermore, the policy of the Federal Reserve Board with respect to private investment funds affiliated with bank holding companies favors the limited liability company format over the limited partnership format. Many private investment companies that have converted or expect to convert to Section 3(c)(7) status also need to convert to limited liability company status because of this Federal Reserve Board policy.[5] If the Commission does not agree with the analysis above, private investment companies affiliated with bank holding companies may be unfairly and inadvertently penalized.

* * *

We appreciate the opportunity to identify interpretive issues and make recommendations concerning the

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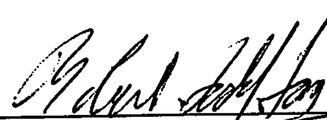
5. Many of those funds are managed by firms that were recently acquired by bank holding companies.

new Rules. Members of the Subcommittee are available to meet with the Staff of the Commission to review the interpretive issues and recommendations set forth herein.

Respectfully submitted,



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