

**Securities Industry Association**

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February 12, 1997

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

Re: Rules Implementing Amendments to the Investment Company Act of 1940, Release No. IC-22405, File No. S7-30-96

Dear Mr. Katz:

The Investment Company, Capital Markets and Federal Regulation Committees ("the Committees") of the Securities Industry Association ("SIA") are taking this opportunity to comment on proposed new rules under the Investment Company Act of 1940 (the "Act") to implement provisions of the National Securities Markets Improvement Act of 1996 ("NSMIA") relating to private investment companies.

GENERAL OVERVIEW

We believe that NSMIA's creation of a new category of private investment company, designed to allow participation by unlimited numbers of "qualified purchasers" without registration under the Act, is a very positive development. It is positive not only because of its favorable impact on the capital formation process in the United States, but also because it should enable regulatory entities to direct more of their finite resources toward protecting investors in need of protection.

It is obvious from the depth and comprehensiveness of the proposed rules that the Staff has applied a great amount of energy and skill to their development. Clearly, they have made a concerted effort to foreclose every approach that might be utilized to subvert NSMIA's intent to limit participation in this new category of private investment company to truly "qualified purchasers". While they have largely succeeded, we are concerned that the scope and complexity of the proposed rules will unduly restrict investment by legitimately qualified purchasers, or discourage use of the new private investment vehicle.

The Committees' concerns center on; the definition of "investments" for purposes of meeting the respective \$5 and \$25 million investment threshold tests for individuals and institutions; the valuation of investments, particularly in terms of the treatment of indebtedness; and the standard for allowing conversion to or investment in a new rule 3(c) (7) fund by a rule 3(c) (1)

fund. While the discussion below will primarily focus on these areas of concern, we will also offer comments on certain other subjects on which the Commission has requested such comment.

INVESTMENTS

We believe that the criteria employed in the proposed rules for calculating the value of an investment for purposes of meeting the \$5/\$25 million threshold test are, in certain respects, too restrictive. While NSMIA grants the Commission authority to define the term "investments", there is no suggestion Congress intended to limit the definition solely to those "investments" which reflect investor sophistication. Ability to afford risk should also be a factor in determining suitability. Those investors who are willing and financially able to afford the risks of investing in an unregulated vehicle should be permitted to do so. Therefore, even passive or family business investments should be given some weight. In that regard it is suggested that net worth, regardless of the nature of its investment components, be factored into the qualified purchaser criteria in a number of different ways. For example, there should be a de minimis standard for section 3(c) (7) investments where the investor has substantial net worth and the investment does not exceed a modest percentage of the investor's total net worth. Also, to the extent that some documentation requirement may exist, where a potential investor's net worth exceeds a certain amount, 3(c) (7) fund sponsors should be entitled to explicitly rely on the investor's representations as to compliance with the threshold "investment" requirement, rather than being required to inquire further with respect to the underlying information. We suggest that these standards be triggered when a prospective individual investor or institutional investor reasonably certifies to a total net worth of at least \$10 million or \$50 million, respectively. Such an approach would more closely resemble that frequently used with similar investors in other capital raising contexts.

Aside from the fact that very high net worth investors clearly would be deemed suitable for the higher risk unregistered offerings, they certainly may object to furnishing detailed financial data on unrelated investments, and should not be precluded from making a de minimis investment in a 3(c) (7) fund merely because they exercise their right to reasonable privacy.

CASH AND CASH EQUIVALENTS

We appreciate the Staff's recognition of the fact that investor cash and cash equivalent positions may reflect conscious investment decisions to maintain a defensive strategy and thus cash can be held for "investment purposes." However, the proposed rule would still require a determination as to when an "investment purpose" exists. This could easily lead to the development of an extensive body of interpretive letters and releases attempting to define the term. Such standards would at best be arbitrary and difficult to apply. For example, if an investor maintains a cash management account at a broker-dealer with checking account and credit card features which can be used to satisfy personal obligations, does this "taint" all of the cash or cash equivalents in the account? If not, what portion is tainted, and how would one determine that? Also, how does one determine whether cash is awaiting reinvestment? Would one have to calculate the average time between prior sales and reinvestment of proceeds and elude from investments cash that was held longer than the average? What happens if market conditions have changed?

Because of the arbitrariness of any requirements that may be imposed and the burdens they would place on calculating investments for purposes of meeting the applicable threshold, we believe proposed rule 2a-1(b) (5) should be modified to include a presumption that most or all cash held in an account is held for investment purposes.

TREATMENT OF INDEBTEDNESS

The Committees believe that the value of an investment which is collateralizing a debt obligation, regardless of when the debt was incurred, should be offset by the amount of indebtedness. A securities margin account where only the net equity would be considered, is one example of this. A bank loan collateralized by specific securities is another. We do not believe, however, that debts not collateralized by includable investments should be presumed to have been incurred to fund such investments if incurred within twelve months prior to the investment. Such an approach is unworkable, imprecise and arbitrary. First, it is questionable whether investors will willingly provide detailed debt history information with regard to debts not specifically collateralizing investments. Second, even if such debt information were provided, apportioning the debt between investments and other expenditures would be arbitrary and imprecise. Therefore, we respectfully suggest that the rules should require that indebtedness be deducted from the value of an investment only where the investment collateralizes the debt. In such cases, we believe it would be appropriate to require that an investor provide a written representation that no indebtedness was incurred (other than indebtedness collateralized by an actual investment) in connection with the acquisition of qualifying investments. Sponsors of 3(c)(7) funds should be able to explicitly rely on such representation, unless they have reason to know otherwise. We also suggest that, with respect to investors who have investments in excess of a certain value (perhaps \$10 million), the inquiry regarding indebtedness need not be made, or representations obtained regarding indebtedness, since at some level it becomes unlikely that the net equity in investments would fall below the threshold level even if leveraging were maximized.

DOCUMENTATION

Comment was requested on whether rule 2a51-1 should include a list of documentation that could be reasonably relied upon to establish that a prospective investor in a 3(c) (7) fund is a qualified purchaser. While such a non-exclusive safe harbor has some appeal, there is significant concern that given the broad array of possible qualifying purchaser investments, such a list would be necessarily incomplete and discourage reliance on perfectly reasonable other documentation. Therefore, the Committees do not favor development of a documentation list.

We also suggest that the 3(c) (7) fund be permitted reasonably to rely on certified representations of qualified third parties (or of the investors, in high net worth situations) as to an investor's qualified purchaser status, without a duty independently to review the information which provided the basis for the representation. This will significantly expedite the qualification process and correspondingly the formation of 3(c) (7) funds, which is a key objective of NSMIA.

NON-INTEGRATION OF A GRANDFATHERED FUND: THE SAFE HARBOR

The Commission requested comment on the proposed integration safe harbor. It is our understanding that the purpose of this safe harbor is to prevent hedge fund managers from utilizing Section 3(c)(1) and 3(c)(7) in a manner inconsistent with the clear intent of both Congress and the Commission, to wit, by combining a grandfathered 3(c)(7) fund with 100 non-qualified investors, and a new 3(c)(1) fund, to evade the 100 investor limitation.

To respond to these concerns, the Commission has proposed a non-exclusive safe harbor which provides that a grandfathered fund will be treated as an issuer excepted under section 3(c)(7) of the Act if, at the time the new section 3(c)(1) fund offers its securities, 25% or more of the value of all securities of the grandfathered fund is held by qualified purchasers that acquired these securities after October 11, 1996.

We believe that the 25% is higher than necessary and would suggest that a threshold of between 10% and 15% would be appropriate. We also believe that in all qualified purchasers be counted toward the threshold, not merely those who acquired the securities after October 11, 1996. In addition, while the proposed safe harbor would provide a vehicle for addressing the Commission's concerns, we believe an additional approach would be to permit a manager of a 3(c)(1) fund that wishes to maintain the existing 3(c)(1) and establish a new parallel 3(c)(7) fund, to transfer any qualified purchasers, who consent to the transfer, to the new 3(c)(7) fund. This approach is desirable in that it allows the 3(c)(1) fund to continue unchanged, thereby providing the investors the benefit of the continuity of the investment they had initially made. It also preserves the integrity of the 3(c)(1) fund, making administration simpler and more cost-effective for the manager, which also directly benefits the investors.

In order to use this simplified approach, it will be imperative that a tax safe harbor be established which provides that if the transfer is between funds that are identical, save for their reliance on 3(c)(1) or 3(c)(7), and the fund manager transfers securities in kind, there will be no tax consequences as a result of this transfer.

THE CONSENT PROVISION

The consent provision requires that a private fund that wishes to become a qualified purchaser obtain the consent of all of its beneficial owners that had invested in the purchasing fund prior to April 30, 1996. We believe that this is impractical and beyond the protection needed by investors in an existing private fund.

We believe that in lieu of consent, the beneficial owners of the purchasing fund should be provided with notice, and the right to redeem. This would make this procedure consistent with the procedure for grandfathering an existing 3(c) (1) fund into a 3(c) (7) fund, and with documentation of the relevant partnership.

OFF SHORE INVESTORS

The Investment Company Release and proposed rules are silent regarding the treatment of offshore investors with respect to 3(c) (7) "qualified purchaser" status. Various interpretive letters have indicated that such investors do not have to meet the qualified purchaser requirements in order to invest in 3(c) (1) funds. It is believed that the same interpretation would apply to 3(c) (7) funds but this should be clarified in the final rules or adopting release.

INVESTMENT BY KNOWLEDGEABLE EMPLOYEES

The Committees support proposed rule 3c-5 which would permit directors, general partners and certain other knowledgeable employees of 3(c) (1) or 3(c) (7) funds to invest in the respective funds without regard to either the 100 investor limit or meeting the "qualified purchaser" criteria, as the case may be. However, we believe the rule should go further to permit other senior sophisticated employees of the fund, or affiliated entities, to invest in such funds. This would enable 3(c) (1) and 3(c) (7) funds to be used as investment vehicles as part of a package of employee benefits for specified classes of employees. We do not believe that clerical or similar employees of a fund, or affiliated entities, should be permitted to invest in the funds.

SUMMARY AND CONCLUSION

Based upon the foregoing our recommendations and conclusions include the following:

- There should be a presumption of "qualified purchaser" status for investors making "de minimis" contributions in relation to their net worth.
- Cash and cash equivalents should be presumed to be "investments".
- Indebtedness should not be deducted from the value of an investment for purposes of determining qualified purchaser status unless the investment collateralizes the indebtedness.
- Proposed rule 2a 51-1 should not include a documentation list.
- The final rules or adopting release should clarify the qualified purchaser status of off shore investors for sections 3(c)(7) purposes.
- Proposed rule 3c-5 should be expanded to allow all senior sophisticated fund and affiliate employees to participate in 3(c) (7) funds created as part of an employee benefits package.

The Committees appreciate the opportunity to comment on these very significant implementing rules. These proposals are a by-product of one of the broadest revisions in the federal securities laws in the last sixty years and will have a long-term impact on the capital formation and regulatory oversight processes. Therefore, we believe that the impact must be closely monitored, and that the Commission should be prepared to seek industry input, and to exercise its exemptive authority under NSMIA, to make further modifications as circumstances warrant. We, of course, are always prepared to speak or meet with the Staff to discuss any of the matters contained in this letter, or other issues related to the private investment company provisions of NSMIA. In that regard the staff may contact any of the undersigned at the telephone numbers indicated below or SIA Staff member Mike Udoff at 212-618-0509. Thank you.

Sincerely,

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