ACT ICA
SECTION 2(a)(51) + 3(c)(7)
RULE 2a51-1
PUBLIC AVAILABILITY 12-29-97

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Sullivan & Cromwell
File No. 132-3

RESPONSE OF THE OFFICE OF CHIEF COUNSEL
DIVISION OF INVESTMENT MANAGEMENT

Your letter of November 4, 1997 requests the staff's concurrence with your view that, for purposes of determining a natural person's status as a qualified purchaser under Section 3(c)(7) of the Investment Company Act of 1940 (the "Act"), the person's equity interest ("Equity Interest") in a securities-related business, even if that interest is not a security, may be considered an "investment" under Section 2(a)(51) of the Act and Rule 2a51-1 promulgated thereunder, under the circumstances described below.

You state that you represent business entities that are organized as limited or general partnerships, or limited liability companies ("Firms"). The Firms are structured as partnerships or limited liability companies to avoid corporate level tax. The Firms are not public companies within the meaning of Rule 2a51-1(a)(7) of the Act.[1] Each Firm has owners' equity in excess of $50 million dollars. The Firms, directly or indirectly through affiliated persons, are primarily engaged in securities-related businesses, and thus are excluded from the definition of investment company pursuant to Section 3(c)(2) of the Act.[2]

You represent that the Equity Interests in each Firm are held by the principals, senior executives and managers of the Firm, and in some instances by retired executives and managers and members of their immediate families ("Interestholders").[3]

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[1] Rule 2a51-1(a)(7) defines a "Public Company" to include those companies that file periodic reports pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 or that have a class of securities listed on a "designated offshore securities market" as defined in Regulation S under the Securities Act of 1933.

[2] Section 3(c)(2) excepts from the definition of investment company "any person primarily engaged in the business of underwriting and distributing securities issued by other persons, selling securities to customers, and acting as broker, and acting as market intermediary, or any one or more such activities, whose gross income normally is derived principally from such business and related activities."

[3] You represent that some of the Interestholders may be deemed to "control" a Firm either through ownership of more than 25% of the Equity Interests or through their ability to affect the management of a Firm within the meaning of Section 2(a)(9) of the Act.

The Equity Interests in the Firm generally reflect the partner's or member's capital account or an indivisible pro rata interest in the net worth of the Firm. You represent that the Equity Interests generally are the Interestholder's most significant financial asset.

Each Firm either prohibits or imposes severe limitations on the transferability and assignability of Equity Interests. Some of the Equity Interests of Firms organized as general or limited partnerships are inextricably tied to the management of the Firms. Because of these characteristics, you state that the Equity Interests may not fall within the definition of a "security" under Section 2(1) of the Securities Act of 1933.

Analysis

Section 3(c)(7) of the Act provides an exclusion from the definition of investment company for certain issuers whose securities are owned exclusively by "qualified purchasers." The underlying rationale of Section 3(c)(7) is that "financially sophisticated investors are in a position to appreciate the risks associated with investment pools that do not have the Investment Company Act's protections."[4] Consistent with this rationale, Section 2(a)(51) of the Act, in pertinent part, defines a "qualified purchaser" to include any natural person who owns in the aggregate at least $5 million in "investments." Congress delegated to the Commission the task of defining the term "investment" for purposes of Section 2(a)(51).[5]

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[4] S. Rep. No. 293, 104th Cong., 2d Sess. at 10 (1996) ("Senate Report"). See also Hearings on S. 1815, The Securities Investment Promotion Act of 1996, Before the Committee on Banking, Housing and Urban Affairs, 104th Cong., 2nd Sess. at 9 (1996) (written testimony of Arthur Levitt, Chairman, U.S. Securities and Exchange Commission).

[5] Congress instructed the Commission, in defining "investment," to consider, among other things, "the participant's net worth, knowledge and experience in financial matters, and amount of assets owned or under management." Senate Report, supra note 4, at 10. Specifically, Congress stated that it expected "that the SEC would define 'investments' to include assets held for investment purposes." Id. In the Release adopting the final rules to implement Section 3(c)(7), the Commission noted that "Congress expected that the definition of investments would be broader than securities, but not that every asset should be treated as an investment." Privately Offered Investment Companies, Investment Company Act Release No. 22597 (Apr. 3, 1997) (the "Adopting Release").

Paragraph (b)(1) of Rule 2a51-1 defines "investments" generally to include securities, but to exclude securities that represent a controlling interest in an issuer ("controlled issuer exclusion"). The Rule, however, does not exclude from the definition of "investments" securities that represent a controlling interest in three type of issuers: (i) Investment Vehicles[6]; (ii) Public Companies[7]; or (iii) companies with shareholders' equity of not less than $50 million. The purpose behind the controlled issuer exclusion was to exclude from the definition of "investments" those interests, such as controlling ownership interests in family-owned and other closely held businesses, that may not demonstrate the requisite "degree of financial sophistication necessary to invest in unregulated investment pools."[8] The purpose underlying the three exceptions to the controlled issuer exclusion was to include as investments those assets that suggest that the holder has significant experience in investments or financial matters.[9]

You state that some of the Equity Interests issued by the Firms do not fall within the literal definition of "investments" in Rule 2a51-1(b) because they are not securities (nor do they fit into any of the other categories of assets included within the definition). Nevertheless, you contend that such Interests should be treated as securities, and thus as investments, for purposes of Rule 2a51-1. In support of this contention, you note that the Equity Interests have many of the characteristics of securities. In particular, you represent that the economic characteristics of the Equity Interests are substantially similar to those attributable to the common stock of broker-dealer firms and other securities-related businesses organized as corporations. You note that the Equity Interests would be securities if the Firms were organized as corporations, rather

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[6] Rule 2a51-1(a)(3) defines the term "Investment Vehicle" to mean a commodity pool, an investment company, a company that would be an investment company but for the exclusions in Sections 3(c)(1) through (9) of the Act, or a company relying on Investment Company Act Rules 3a-6 or 3a-7.

[7] See supra note 1 (definition of the term "Public Company").

[8] Adopting Release, supra note 5. See also Senate Report, quoted supra at text accompanying note 4.

[9] See Adopting Release, supra note 5 (a holder's controlling interest in (i) an Investment Vehicle suggests a significant degree of investment experience, (ii) a Public Company suggests significant experience in financial matters and investments, (iii) a large private company suggests sophistication and significant financial acumen).

than as partnerships or limited liability companies. You contend that, for purposes of determining whether a natural person has $5 million worth of investments and thus may be deemed a "qualified purchaser" permitted to invest in private investment pools, there is no reason that individuals owning equity interests in securities-related businesses structured as partnerships or limited liability companies should be disadvantaged compared with those owning equity interests in securities-related businesses structured as corporations.

We agree. In considering which assets to treat as investments for purposes of determining a natural person's status as a qualified purchaser, both Congress and the Commission clearly indicated an intention to include assets that demonstrate that its holder has the investment experience and sophistication necessary to evaluate the risks of investing in unregulated investment pools.[10] We believe that ownership of an interest in a securities-related business demonstrates the requisite degree of investment experience and sophistication, regardless of whether the business is organized as a corporation, partnership, or limited liability company. Accordingly, we conclude that the Equity Interests in the Firms should be treated as securities for purposes of Rule 2a51-1(b)(1).[11]

You state that some of the Equity Interests are controlling interests while others are not.[12] Rule 2a51-1(b)(1) provides that securities representing less than a controlling interest in an issuer are "investments" within the meaning of Section 2(a)(51). Securities that represent a controlling interest in an issuer, by contrast, are "investments" only if they qualify for an exception from the controlled issuer exclusion. You represent that the Firms qualify for two of the exceptions. First, each of the Firms is an Investment Vehicle because it is eligible for an exclusion from the definition of investment company by Section 3(c)(2).[13] Second, each of the Firms has shareholders' equity in

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[10] See supra notes 4, 8 and 9 and accompanying text.

[11] You have not requested our view, and we express none, regarding whether an Equity Interest in a Firm structured as a general partnership or a limited liability company is, or would be treated as, a security for purposes of the Securities Act of 1933 or any other provision of the federal securities laws. Our position that Equity Interests in Firms may be treated as securities is limited solely to Sections 2(a)(51) and 3(c)(7) of the Investment Company Act and Rule 2a51-1 thereunder.

[12] See supra note 3.

[13] See supra note 2 (explanation of Section 3(c)(2)) and note 6 (definition of the term "Investment Vehicle").

excess of $50 million.

For the reasons set forth above, we concur with your view that, for purposes of determining a natural person's status as a qualified purchaser under Sections 2(a)(51) and 3(c)(7) of the Investment Company Act and Rule 2a51-1 thereunder, the person's Equity Interest in a Firm may be treated as a "security." Because each Firm qualifies for one of the exceptions to the controlled issuer exclusion, the staff would not object if an Interestholder's Equity Interest in a Firm, whether or not it constitutes a controlling interest, is treated as an "investment" within the meaning of Section 2(a)(51) of the Investment Company Act and Rule 2a51-1 thereunder. The staff's position is based upon the facts and representations contained in your letter. Any different facts or representations may require a different conclusion.

Eileen M. Smiley
Senior Counsel

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November 4, 1997

By Hand

Mr. Barry A. Mendelson,
Senior Special Counsel,
Division of Investment Management,
Securities and Exchange Commission,
450 Fifth Street, N.W.,
Washington, D.C. 20549.

Re: Request for Interpretive Relief Relating to the Definition of Investments for Purposes of Determining a Qualified Purchaser

Dear Mr. Mendelson:

We are writing on behalf of business organizations of the kind described below (the "Firms") and owners ("Interestholders") of the equity of these Firms ("Equity Interests"). We request your confirmation that an Interestholder or a "Section 3(c)(7) Company"* may include Interestholders' Equity Interests as "investments" for purposes of section 2(a)(51) of the Act.

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* As such term is defined in rule 2a51-1(a)(10) under the Investment Company Act of 1940 (the "Act").

We represent certain Firms that share the following characteristics. First, these Firms are not organized as corporations, but rather as limited or general partnerships or limited liability companies. As a result, the Equity Interests of some or all of the Interestholders may not be "securities", as such term is defined in section 2(1) of the Securities Act of 1933 (the "Securities Act"). Second, these Firms are not Public Companies within the meaning of rule 2a51-1(a)(7) and have owners' equity in excess of $50 million. Lastly, these Firms are directly or indirectly* through affiliated persons (by virtue of control) engaged primarily in securities-related businesses which operate in a manner so as to be excluded from the definition of investment company by section 3(c)(2) of the Act.

The Firms generally have been structured as partnerships or limited liability companies in order to avoid corporate level tax. The Equity Interests in the Firms generally reflect the partner's or member's capital

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* Each Firm that is indirectly engaged in such businesses through an affiliated person excluded from the definition of investment company by section 3(c)(2) is either (i) not an investment company within the meaning of section 3(a)(1)(C) of the Act or (ii) excluded from the definition of investment company by sections 3(c)(1) through 3(c)(9) of the Act or exempted from such definition by rule 3a-6 thereunder.

account, or an indivisible pro rata interest in the net worth of a Firm. In this respect, the Equity Interests resemble, but are not directly analogous to, the common or preferred stock of a corporation. A partner's interest in the profits and losses, or any agreed fixed return, is allocated to his or her Equity Interest from time to time. To the extent the amounts allocated are not distributed to partners, the increase in the value of the Equity Interests is analogous to the increase in the book value of common stock of a corporation.

The Equity Interests generally are held by the principal and most senior executives and managers of the Firms and their respective affiliates and, in some cases, by retired executives and managers and members of their families. Because the Firms are directly or indirectly engaged in securities-related businesses, distributions of income and capital withdrawals are limited (i) by the net capital regulations under the Securities Exchange Act of 1934 applicable to registered broker-dealers and the rules of the various national securities exchanges of which such Firms or their controlled affiliates are members and (ii) more importantly, by the very large capital requirements of modern financial services firms. Each of these limitations is equally applicable to public and

private broker-dealers and broker-dealer holding companies organized as corporations.

For purposes of section 3(c)(7), paragraph (b)(1) of rule 2a51-1 generally includes securities (as such term is defined in section 2(1) of the Securities Act) within the definition of investments.

Because the Equity Interests are held by the most senior executives, are not available to others, either are not transferrable or assignable or are subject to substantial limitations on assignment, and, in the case of general and certain limited partnership and member interests, are inextricably associated with the management of the Firms, the Equity Interests are, notwithstanding their considerable economic value, not generally considered "securities" within the meaning of Section 2(1) of the Securities Act.* On the other hand, these same interests, and their appreciation in value resulting from the success of the businesses of the Firms from their operations and those of their respective affiliated persons, have many characteristics of "securities" viewed from the perspective of any single partner or member. The Equity Interests generally are regarded as the partner's or member's most

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* See, e.g., Williamson v. Tucker, 645 F.2d 404 (5th Cir.), cert denied, 454 U.S. 897 (1981).

significant financial asset. Each of the economic characteristics of the Equity Interests is substantially similar to those attributable to the common stock held by the senior executives of broker-dealer firms organized as corporations, except that, in the case of publicly-held firms, ownership is not limited to senior executives, and market prices rather than internal returns determine the "value" of the equity interests in such firms.

We do not believe that any policy reason requires or that the Commission had intended that the Interestholders of Equity Interests in large securities-related businesses structured as partnerships or limited liability companies should be disadvantaged compared to those organized as corporations (whether or not Public Companies) in determining whether such Interestholders are "qualified purchasers" simply because the Equity Interests, unlike equity interests in corporations, are not "securities" within section 2(1) of the Securities Act. We believe, therefore, that Equity Interests should be treated as securities for purposes of rule 2a51-1(b)(1).

Rule 2a51-1(b)(1) generally excludes from the definition of investments the securities of an issuer that

controls, is controlled by or is under common control* with the prospective qualified purchaser; the rule does not, however, exclude from investments the controlling ownership interests in (i) an "Investment Vehicle",** (ii) a "Public Company",*** or (iii) a company with shareholders' equity of not less than $50 million (determined in accordance with generally accepted accounting principles) as reflected on the company's most recent financial statements.**** The Commission included in the rule these exceptions to the general prohibition against control interests counting as

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* The term "control" is defined in section 2(a)(9) of the Act as "the power to exercise a controlling influence over the management or policies of a company, unless such power is solely the result of an official position with such company".

** Under rule 2a51-1(a)(3), an "Investment Vehicle" means a commodity pool, an investment company or a company that would be an investment company but for the exceptions provided by sections 3(c)(1) through 3(c)(9) of the Act or the exemptions provided by rule 3a-6 or 3a-7 under the Act.

*** Under rule 2a51-1(a)(7), a "Public Company" means a company that (i) files reports pursuant to section 13 or 15(d) of the Securities Exchange Act of 1934 or (ii) has a class of equity securities that are listed on a "designated offshore securities market" as such term is defined by Regulation S under the Securities Act.

**** The rule requires that such financial statements present information as of a date within 16 months preceding the date on which the prospective qualified purchaser acquires the securities of a Section 3(c)(7) Company.

investments where the exceptions "suggested a significant degree of investment experience"* and were not inconsistent with "the legislative history indicating Congress' view that control interests in family-owned and other small businesses may not evidence investment sophistication."**

We note that some Interestholders may be deemed to "control" a Firm, as such term is defined by section 2(a)(9) of the Act, through their beneficial ownership of more than 25% of the voting Equity Interests of the Firm or their power to exercise a controlling influence over the management or policies of the Firm. Assuming that Equity Interests were treated as securities for purposes of rule 2a51-1(b)(1), in order for such controlling Interestholders to count their Equity Interests as investments, the Firm would need to qualify for one of the three exceptions to the exclusion of controlling ownership interests contained in rule 2a51-1(b)(1) (the "Exceptions").

In fact, the Firms qualify for two of the Exceptions. Each of the Firms is "a company with [owners'] equity of not less than $50 million... as reflected on the company's most recent financial statements...." Also, each

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* Release No. IC-22597, International Series Release No. 1071, File No. S7-30-96 (62 FR 17512, April 9, 1997), at section II.A.2.a.

** Id.

of the Firms or their principal directly or indirectly controlled affiliated persons is an Investment Vehicle, because the Firm (or such affiliated person) engages primarily in securities-related businesses in a manner so as to be eligible for an exclusion from the definition of investment company by section 3(c)(2) of the Act.

By reason of qualifying for one of the Exceptions, the common stock issued by a privately held corporation with the number of senior and retired officer stockholders and net worth identical to a Firm would come within the definition of "investments" irrespective of whether any stockholder or stockholders held a controlling interest in such corporation. The degree of a stockholder's participation in the business of the corporation would be irrelevant, even if a stockholder had "the power to exercise a controlling influence over the management or policies of a company". Although an Interestholder may participate in the management of a Firm directly as a partner or member, or as one of a select few highly sophisticated executive officers holding a limited partner or member interest, we submit that there should not be a different result for the Interest-holders in the Firms for purposes of section 2(a)(51) than for such similarly situated stockholders and that, accordingly, the Equity Interests of controlling and non-

controlling Interestholders alike should be treated as "investments" under rule 2a51-1.

Therefore, we believe it is appropriate for an Interestholder or a Section 3(c)(7) Company to include within the definition of investments an Interestholder's Equity Interests in a Firm, without regard to the degree of participation of the Interestholder in the business of the Firm, where (i) the Equity Interests reflect the Interestholder's partnership or membership capital account or indivisible pro rata interest in the net worth of the Firm, and (ii) the Firm (A) is organized other than as a corporation and (B) either (x) has owners' equity of not less than $50 million (determined in accordance with generally accepted accounting principles) as reflected on the company's most recent financial statements or (y) is, or controls an affiliated person that is, a company that is excluded from the definition of investment company by section 3(c)(2) of the Act.

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Please feel free to contact me at 212-558-3866 or Paul McElroy at 202-956-7550 if you have any questions regarding any aspects of this request.

Sincerely,

J E Baumgardner, Jr. /BM

John E. Baumgardner, Jr.

cc: Kenneth J. Berman
Eileen M. Smiley
(SEC Division of Investment Management)