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The Securities and Exchange Commission today made public the following statement.

"Restricted Securities"

The Commission is aware that many investment companies have been acquiring substantial quantities of securities that cannot be offered to the public for sale without first being registered under the Securities Act of 1933 ("restricted securities"). For the year 1968, annual reports filed by registered investment companies indicate that open-end and closed-end companies together held in excess of $4.2 billion of restricted equity securities. Open-end companies—excluding exchange funds—accounted for about $3.2 billion of these restricted securities which represented 4.4 per cent of their total net assets. The acquisition by investment companies of such securities raises certain problems under the securities laws of which shareholders, distributors, managements and directors of these companies should be aware. This statement discusses these problems. No inference should be drawn from publication of this statement, however, as to the desirability or merits of the acquisition of restricted securities by a registered investment company.

Problems for the Seller

Section 4(2) of the Securities Act of 1933 exempts from the registration requirements of that Act "transactions by an issuer not involving any public offering." This is the so-called "private offering" provision in the Securities Act. The securities involved in transactions effected pursuant to this exemption are referred to as restricted securities because they cannot be resold to the public without prior registration. They are also sometimes referred to as "investment letter securities" because of the practice frequently followed by the seller in such a transaction, in order to substantiate the claim that the transaction does not involve a public offering, of requiring that the buyer furnish a so-called "investment letter" representing that the purchase is for investment and not for resale to the general public.

The private offering exemption of Section 4(2) of the Securities Act is available only where the offerees do not need the protections afforded by the registration procedure. As the Court of Appeals for the Second Circuit recently stated in *Katz v. Amos Treat & Co.,* CCH FEDERAL SECURITIES LAW REPORTS ¶92,409 (1969):

"The Supreme Court has instructed that the applicability of the exemption should turn on whether the particular class of persons affected need the protection of the Act. *SEC v. Ralston Purina Co.,* 346 U.S. 119, 125 (1953)."

The test of the availability of the Section 4(2) exemption is whether the offerees are in such a position with respect to the issuer as to have access to the kind of information that would be made available in a registration statement filed pursuant to the Securities Act. This test is no different when the offeree is an investment company.

Problems for the Buyer

1. *The Problems of Valuation*

It is critically important that an investment company properly value its portfolio securities. It is obvious, for example, that any distortion in the valuation of a restricted security held by an investment company will distort the price at which the shares of the investment company are sold or redeemed. It is also clear that investment managers who are compensated on the basis of net asset value or performance may be unduly compensated if a restricted security, purchased at a discount from the market quotation for unrestricted securities of the same class, is overvalued. In such a case, investors may also be misled by the reported performance of the investment company.

The acquisition of restricted securities by both open-end and closed-end investment companies creates serious problems of valuation. Section 2(a)(39) of the Investment Company Act of 1940 and Rule 2a-4 thereunder requires that in determining net asset value, "securities for which market quotations are readily available" must be valued at current market value while other securities and assets must be valued at "fair value as determined in good faith by the board of directors."

Readily available market quotations refers to reports of current public quotations for securities similar in all respects to the securities in question. No such current public quotations can exist in the case of restricted securities. For valuation purposes, therefore, restricted securities constitute securities for which market quotations are *not* readily available. Accordingly, their fair values must be determined in good faith by the board of directors and this obligation necessarily continues throughout the period these securities are retained in the company's portfolio.

Restricted securities should be included in the portfolio of a company and valued to determine current net asset value on the date that the investment company has an enforceable right to demand the securities from the seller.

Where the investment company negotiates the acquisition of the restricted securities directly with the owner of the securities, there are three significant dates. The first occurs when the investment company and the seller orally agree upon the price and the amount of the securities (the "handshake date"). At this point, there would not seem to be any enforceable right of the investment company to demand the securities from the seller since, in most states, particularly those which have adopted the Uniform Commercial Code, there is no enforceable right unless there exists some writing "sufficient to indicate that a contract has been made for sale of a stated quantity of described securities at a defined or stated price" (Section 8-319(a) of the Uniform Commercial Code). If the terms of the oral understanding do not contemplate compliance with any condition by the seller, it is suggested that the investment company procure, from the seller, a signed memorandum setting forth the price and quantity of securities to be sold. Upon receipt of that memorandum, an enforceable right would be obtained. The securities should be valued as of that date.

In those situations where the oral understanding contemplates the execution of a formal contract of purchase and sale, no enforceable right exists until the time the formal contract is signed (the "contract date"). If the formal contract does not require compliance with any conditions by the seller, an enforceable right is then obtained, and the securities should be valued as of that date.

Where the formal contract requires compliance with stated conditions which the investment company believes should not be waived, no enforceable right is obtained until the stated conditions are satisfied. In that situation, the valuation date should be the date upon which the conditions are satisfied (the "closing date").

Restricted securities are often purchased at a discount, frequently substantial, from the market price of outstanding unrestricted securities of the same class. This reflects the fact that securities which cannot be readily sold in the public market place are less. valuable than securities which can be sold, and also the fact that, by the direct sale of restricted securities, sellers avoid the expense, time and public disclosure which registration entails.

As a general principle, the current fair value of restricted securities would appear to be the amount which the owner might reasonably expect to receive for them upon their current sale. This depends upon their inherent worth, without regard to the restrictive feature, adjusted for any diminution in value resulting from the restrictive feature. Consequently, the valuation of restricted securities at the market quotations for unrestricted securities

of the same class would, except for most unusual situations, be improper. [1] Further, the continued valuation of such securities at cost would be improper if, as a result of the operations of the issuer, change in general market conditions or otherwise, cost has ceased to represent fair value. In such circumstances, maintaining the value of the restricted securities at cost would mislead investors as to the value of the portfolio of the investment company which holds restricted securities.

Instead of valuing restricted securities at cost or at the market value of unrestricted securities of the same class, some investment companies value restricted securities held in their portfolio by applying either a constant percentage or an absolute dollar discount to the market quotation for unrestricted securities of the same class. The automatic valuation of restricted securities by such a method, however, would also not appear to satisfy the requirement of the Act that each security, for which a market quotation is not readily available, be valued at fair value as determined in good faith by the board of directors.

Thus, it would be improper in valuing restricted securities automatically to maintain the same percentage discount (from the market quotation for unrestricted securities of the same class) that was received when the restricted securities were purchased, without regard to other relevant factors such as, for example, the extent to which the inherent value of the securities may have changed.

Furthermore, the valuation of restricted securities by reference to the market price for unrestricted securities of the same class assumes that the market price for unrestricted securities of the same class is representative of the fair value of the securities. This may not be the case when the market for the unrestricted securities is very thin, *i.e.,* only a limited volume of shares is available for trading. With a thin market, the news of the investment company's purchase of the restricted securities may, by itself, have the effect of stimulating a public demand for the unrestricted securities, the supply of which has not been increased, and thus lead to a spiralling increase in the valuation of both the restricted and unrestricted securities.

Moreover, if, in valuing restricted securities, the diminution in value attributable to the restrictive feature is itself affected by factors subject to change, such as the length of time which must elapse before the investment company may require the issuer to cause the securities to be registered for public sale, the valuation should reflect any such changes.

Some companies value restricted securities, acquired at prices below the market quotations for unrestricted securities of the same class, by automatically amortizing the difference over some chosen period on the assumption that it will be possible to sell them at the market price for unrestricted securities at the expiration of the time period. Under prevailing conditions, however, it cannot always be determined either that the securities will, in fact, be effectively registered at the expiration of that period or that their public sale will otherwise be possible. For example, the issuer may be unable or unwilling to register at the expiration of the estimated period, and public sale at the end of that period without registration may not be lawful. Consequently, the practice of automatically amortizing the discount over an arbitrarily chosen period creates the appearance of an appreciation in the value of the securities which has not, in fact, occurred, and, accordingly, is improper.

An undertaking by the issuer to register the securities within a specified time period would not dictate a different result. In view of the many factors that may alter the date of the proposed public offering, it is at best speculative to use such an undertaking alone as the basis for amortizing the discount.

Similarly, the possible adoption by the Commission of the more definite holding periods contained in proposed Rules 101, 160, 161, 162, 163, 164, and 180, Securities Act Release No. 4997 (dated September 15, 1969) would also not alter the conclusion that amortization of the discount may be improper. The more definite holding periods there proposed are available only if certain specified conditions are met.

In summary, there can be no automatic formula by which an investment company can value restricted securities in its portfolio to comply with Section 2(a)(39) and Rule 2a-4. It is the responsibility of the board of directors to determine the fair value of each issue of restricted securities in good faith; and the data and information considered and the analysis thereof should be retained for inspection by the company's independent auditors. While the board may, consistent with this responsibility, determine the method of valuing each issue of

restricted security in the company's portfolio, it must continuously review the appropriateness of any method so determined. The actual calculations may be made by persons acting pursuant to the direction of the board.

2. *The Problems of Portfolio Management*

In addition to valuation, restricted securities present special problems of portfolio management.

The concept of the Securities Act exemption of a private placement of securities is premised on the belief that in such a situation the investor has such information concerning the issuer that he is able to fend for himself without need for the disclosures that would be provided by an effective registration statement. Correlatively, where the investor is a registered investment company, it would seem to be the fiduciary duty of the persons responsible for the investment decisions of the investment company to obtain, prior to purchase, the necessary information to make an independent analysis of the investment merits of the particular restricted securities. [2] Also, in order to enable the continuing valuation of such securities, the investment company should require the seller to undertake to provide, to the extent known to the seller, information on a continuing basis as to any subsequent private sales of the issuer's securities. The investment company should also assure itself that it is in the position to obtain the appropriate financial information at appropriate times. It is assumed that any public disclosures, such as that made in periodic reports filed pursuant to the Securities Exchange Act, are carefully considered by the investment company portfolio manager.

There is also the paradox of too much success to consider. For example, if restricted securities rapidly appreciate in value, perhaps because of an improvement in the business of the issuer, an investment company may find instead of having, for example, 5 per cent of its assets invested in a particular company, it has instead, 25 per cent of its assets in that company. The investment company to which this happens suffers a loss in diversification and may find that it has become overly sensitive to any adverse developments in the affairs of that particular portfolio company.

The foregoing factors in portfolio management relate to both open-end and closed-end management companies. There are additional special factors that relate only to open-end companies.

Section 2(a)(31), when read together with Section 5(a), of the Investment Company Act requires that the holders of redeemable shares issued by an open-end investment company be entitled to receive approximately their proportionate share of the issuer's current net assets, or the cash equivalent thereof, upon presentation of the security to the issuer or to a person designated by the issuer. Section 22(e) of the Act provides that, absent specified unusual conditions, payment of the redemption price must be made within seven days after the tender of a redeemable security to an investment company or its agent designated for that purpose.

It is desirable that an open-end company retain maximum flexibility in the choice of portfolio securities which, on the basis of their relative investment merits, could best be sold where necessary to meet redemptions. To the extent that the portfolio consists of restricted securities, this flexibility is reduced.

Restricted securities may not be publicly sold—nor can they be distributed to redeeming shareholders as an in-kind redemption. While they may be sold privately, there may not be sufficient time to obtain the best price since the date of payment or satisfaction may not be postponed more than seven days after the tender of the company's redeemable securities for redemption. A private sale within that period may result in the investment company receiving less than its carrying value of the restricted securities. This would result in a preference in favor of the redeeming shareholders and a diminution of the net asset value per share of shareholders who have not redeemed. Therefore, instead of arranging a private sale of restricted securities, an open-end company that is faced with redemptions may decide to sell unrestricted securities which it would otherwise have retained on the basis of comparative investment merit.

Significant holdings of restricted securities not only magnify the valuation difficulties but may also present serious liquidity questions. Because open-end companies hold themselves out at all times as being prepared to meet redemptions within seven days, it is essential that such companies maintain a portfolio of investments that enable them to fulfill that obligation. This requires a high degree of liquidity in the assets of open-end companies because the extent of redemption demands or other exigencies are not always predictable. It has been with

this in mind that the staff of the Commission has for several years taken the position that an open-end company should not acquire restricted securities when the securities to be acquired, together with other such assets already in the portfolio, would exceed 15 per cent of the company's net assets at the time of acquisition. The Commission, however, is of the view that a prudent limit on any open-end company's acquisition of restricted securities, or other assets not having readily available market quotations, would be 10 per cent. [3] When as a result of either the increase in the value of some or all of the restricted securities held, or the diminution in the value of unrestricted securities in the portfolios, the restricted securities come to represent a larger percentage of the value of the company's net assets, the same valuation and liquidity questions occur. Accordingly, if the fair value of restricted holdings increases beyond 10 per cent, it would be desirable for the open-end company to consider appropriate steps to protect maximum flexibility. The Commission will re-examine appropriate limitations in this area in light of all the policy objectives of the Investment Company Act.

3. *The Problem of Disclosure*

Section 8(b)(1)(D) of the Investment Company Act requires that an investment company include, in its registration statement filed with the Commission under the Act, information as to its policy with respect to "engaging in the business of underwriting securities issued by other persons." Item 4(c) of Form N-8B-1 requires that a registrant under the Act describe its policy or proposed policy with respect to "the underwriting of securities of other issuers." In response to this item, registrant's policy with respect to the acquisition of restricted securities should be disclosed. [4] In view of the fact that policies listed under Item 4 are fundamental policies which cannot be changed without prior shareholder approval, the importance of adopting a clear policy with regard to such investments is apparent.

The prospectus of a registered investment company should also fully disclose the company's policy with respect to restricted securities. [5] It is also clear that an investment company which has a policy of acquiring restricted securities is responsible for full and adequate disclosure with respect to all matters relating to the valuation of such securities. Specifically, there should be included, in a note to the financial statements, (1) identification of any restricted securities and the date of acquisition, (2) disclosure of the methods used in valuing such securities both at the date of acquisition and the date of the financial statements, (3) disclosure of the cost of such securities and the market quotation for unrestricted securities of the same class both on the day the purchase price was agreed to (the so-called "handshake date"), and on the day the investment company first obtained an enforceable right to acquire such securities, and (4) a statement as to whether the issuer or the registrant will bear costs, including those involved in registration under the Securities Act, in connection with the disposition of such securities.

Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder makes it unlawful, among other things, for any person, in connection with the purchase or sale of securities, to employ any device, scheme, or artifice to defraud or to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made not misleading, or engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any persons.

The offering price of securities issued by a management investment company is premised upon the net asset value of such shares as determined pursuant to Section 2(a)(39) of the Act and Rule 2a-4 thereunder and is so represented in its prospectus. The improper valuation of restricted securities held by such a company would distort the net asset value of the shares being offered or, in the case of an open-end company, redeemed, and would therefore constitute a fraud and deceit within the meaning of Section 10(b) and Rule 10b-5.

An open-end company, of course, represents to investors, in its prospectus, that it will, as required by Section 22(e) of the Act, redeem its securities at approximate net asset value within seven days after tender. To the extent a material percentage of the assets of an open-end company consist of restricted securities which cannot publicly be sold without registration under the Securities Act, the ability of the company to comply with the provisions of the Investment Company Act relating to redemption, and to fulfill the implicit representations made in its prospectus with respect thereto, may be adversely affected. [6] In any such situation, the investment

company concerned and the persons responsible for the sale of its securities should give careful consideration to the possible application of the provisions of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder.

Footnotes

1 See *Proposed Guidelines For The Preparation Of Form N-8B-1,* Investment Company Act Release No. 5633, p. 21 (March 11, 1969) ['67-'69 CCH FEDERAL SECURITIES LAW REPORTS ¶77,675]. Note—The guidelines were subsequently adopted in Investment Company Act Release No. 7221 (June 9, 1972).

2 See *The Value Line Fund v. Marcus* ('64-'66 Transfer Binder) CCH FEDERAL SECURITIES LAW REPORTS ¶91,523 at p. 94,970 (S.D.N.Y. 1965).

3 The Commission is aware that certain open-end companies may have acquired restricted securities in excess of 10 per cent of net assets. It is assumed that such companies will not undertake commitments, beyond any obligation existing on this date, to acquire restricted securities until, in the normal course of business, such holdings are not in excess of 10 per cent of current net asset value.

4 See *Proposed Guidelines For the Preparation of Form N-8B-1,* Investment Company Act Release No. 5633, p. 7 (March 11, 1969) ['67-'69 CCH FEDERAL SECURITIES LAW REPORTS ¶77,675]. Note—See Note 1 regarding the adopted guidelines.

5 See *Proposed Guidelines For The Preparation Of Forms S-4 and S-5,* Investment Company Act Release No. 5634, pp. 11, 13 (March 11, 1969) ['67-'69 CCH FEDERAL SECURITIES LAW REPORTS ¶77,673]. NOTE—The guidelines were subsequently adopted in Investment Company Act Release No. 7220 (June 9, 1972).

6 See *Proposed Guidelines For The Preparation Of Form N-8B-1,* Investment Company Act Release No. 5633, p. 7 (March 11, 1969) ['67-'69 CCH FEDERAL SECURITIES LAW REPORTS [¶77,675]. NOTE—See Note 1 regarding the adopted guidelines.