

PUBLIC

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RESPONSE OF THE OFFICE OF CHIEF COUNSEL
DIVISION OF INVESTMENT MANAGEMENT

Our Ref. No. 94-785-CC
Philadelphia Ventures
Liberty Fund, L.P.
File No. 814-156

Your letter of December 6, 1994 seeks our assurance that we would not recommend enforcement action to the Commission under section 18(i) of the Investment Company Act of 1940 ("1940 Act") if Philadelphia Ventures Liberty Fund, L.P. ("Liberty Fund") issues certain non-voting preferred limited partnership interests ("Participating Securities") to the U.S. Small Business Administration ("SBA").

Liberty Fund, a limited partnership, has applied for a license from the SBA to operate as a small business investment company ("SBIC") and has elected to be regulated as a business development company ("BDC") under the 1940 Act. In addition to issuing limited partnership interests to the public, Liberty Fund proposes to issue debentures and Participating Securities to the SBA to raise funds, as authorized by the Small Business Investment Act of 1958 ("SBIA"). 1/ The provisions of Liberty Fund's limited partnership agreement that confer rights on the holder of Participating Securities will mirror those recommended in a form provided by the SBA to prospective licensees. Consistent with this form, Liberty Fund's Participating Securities will not have voting rights. The SBA has informed Liberty Fund in writing that, because of concerns such as its potential liability to third parties, the SBA takes the position that it will not grant SBIC licenses to entities that seek to confer voting rights on the SBA. 2/ Holders of Liberty Fund's limited partnership interests will have limited voting rights as permitted under state law and required by the 1940 Act.

Section 18(i) of the 1940 Act generally requires that, except as otherwise required by law, every investment company share of stock be a voting stock and have equal voting rights with every other outstanding voting stock. Section 18(i) applies

1/ The Small Business Credit and Business Opportunity Enhancement Act of 1992 amended the SBIA to permit SBICs to issue, and the SBA to purchase or guarantee payments on, a new class of securities, so-called "participating securities." 15 U.S.C. §683 (1994 Supp.). The amendments require, among other things, that participating securities be entitled to certain priority payments if the SBIC makes a profit, as well as a portion of any remaining profits of the SBIC.

2/ Letter from Robert D. Stillman, Associate Administrator for Investment, SBA, to Thomas R. Morse, Liberty Fund (Dec. 15, 1994) attached to this response as Exhibit A ("SBA letter").

to BDCs by operation of section 61(a). 3/ The 1940 Act does not define "equal voting rights," and the legislative history does not discuss the meaning of that phrase. The Commission has stated that, given the absence of any definition or discussion at the Congressional hearings as to the meaning of the equal voting rights requirement, the general purposes of the statute should guide the determination of whether a given proposal violates that requirement. 4/

Although the SBA will have no voting rights as the holder of the Participating Securities, you state that it has substantial regulatory authority over the operations of Liberty Fund that essentially eliminates the need for the SBA to have voting rights. 5/ Moreover, you state that no-action relief would facilitate implementation of the 1992 amendments to the SBIA.

We would not recommend enforcement action to the Commission under section 18(i) if Liberty Fund issues to the SBA Participating Securities that do not confer voting rights. Because this position is based on the facts and representations made in your letter and the SBA letter, particularly the SBA's representation that it will not license SBIC applicants that seek to confer voting rights on the SBA, you should note that any different facts or circumstances might require a different conclusion. Further, this response only represents the Division's position on enforcement action and does not purport to express any legal conclusion on the questions presented.

Barbara Chretien - Dar
Barbara Chretien-Dar
Senior Counsel

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- 3/ Section 61(a) makes certain provisions of section 18 applicable to BDCs.
- 4/ See Solvay American Corp., 27 S.E.C. 971, 973 (Apr. 12, 1948).
- 5/ For example, you state that no transfer of control may occur without SBA approval. In addition, an SBIC issuing participating securities must agree to permit the SBA to exercise certain remedies, including (a) removing the SBIC's officers, directors, or general partners and appointing a receiver in cases of insolvency, extreme capital impairment or other extraordinary events, (b) replacing the SBIC's officers and its general partners or a majority of its directors in cases of willful conflicts of interest or certain instances of non-compliance with SBA rules, and (c) restricting an SBIC's operations if the finances of the SBIC have been improperly managed.

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1940 Act/Section 18(i)

December 6, 1994

ACT ICA
SECTION 18(i)
RULE -
PUBLIC AVAILABILITY 2-14-95

Jack W. Murphy, Esq.
Chief Counsel
Division of Investment Management
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

RE: Philadelphia Ventures Liberty Fund, L.P.

Dear Mr. Murphy:

On behalf of Philadelphia Ventures Liberty Fund, L.P. ("Liberty Fund"), we hereby request the staff's assurance that it will not recommend enforcement action to the Securities and Exchange Commission (the "Commission") if Liberty Fund issues a class of non-voting preferred limited partnership interests ("Participating Securities"). Although the Participating Securities may not meet the literal terms of Section 18(i) of the Investment Company Act of 1940 (the "1940 Act"), we believe that the staff should grant the request because the Participating Securities will not raise the types of concerns that Section 18(i) was intended to address. The relief also will facilitate the implementation of recent amendments to the Small Business Investment Act of 1958 (the "SBIA"),^{1/} contained in the Small Business Credit and Business Opportunity Enhancement Act of 1992 (the "1992 Amendments"),^{2/} that permit the issuance of Participating Securities.

^{1/} 15 U.S.C. § 681 et seq.

^{2/} Pub. L. 102-366 (Sept. 4, 1992). The 1992 Amendments are contained in the 1994 Supplement to 15 U.S.C. §§ 141-720 at 15 U.S.C. §§ 661-662 and 681 et seq.

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BACKGROUND

Liberty Fund is a limited partnership organized under Delaware Law. Liberty Fund has applied for a license from the Small Business Administration ("SBA") to operate as a small business investment company ("SBIC") under the SBIA. Liberty Fund generally will invest in privately-placed equity securities and convertible debt securities of early-stage small capitalization companies, predominantly in the health care, life sciences and information technology industries ("Portfolio Companies"). Liberty Fund also has elected under Section 54 of the 1940 Act to be regulated as a business development company ("BDC") under Sections 55 through 65 of that Act.

To obtain financing for investments in Portfolio Companies, Liberty Fund proposes to issue limited partnership interests ("Units") to the public pursuant to a registration statement that Liberty Fund has filed under the Securities Act of 1933 ("1933 Act") on Form N-2. A copy of the Form N-2, which was filed with the Commission on November 28, 1994, accompanies this letter as Exhibit A. Liberty Fund will offer the Units only to "accredited investors" as defined in Rule 501 of Regulation D under the 1933 Act.

Liberty Fund also proposes to apply for funding from the SBA (so-called "Leverage") by issuing debentures and Participating Securities in transactions that do not require 1933 Act registration. Participating Securities are a new type of equity security that SBICs are permitted to issue as a result of the 1992 Amendments.

Prior to the 1992 Amendments, the SBA was permitted only to guarantee debentures (generally with ten year maturities) issued by SBICs.^{3/} These debentures require payment of interest every six months, with principal due on maturity.^{4/} Interest rates average 75-80 basis points over treasuries with

^{3/} 15 U.S.C. § 683 prior to the 1992 Amendments.

^{4/} 15 U.S.C. § 683(b) and (c) (1994 Supp.); 13 C.F.R. § 201.

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comparable maturities. Higher interest rates in the early 1980's, followed by lower rates at the close of the decade, trapped many SBICs with expensive long-term debentures which could only be repaid with significant penalties. This development underscored a basic flaw in the SBIC program design -- the funding of long term equity investments in Portfolio Companies (with little or no yield) through debentures issued to the SBA requiring significant current interest payments.

The 1992 Amendments authorize the SBA to provide Leverage to SBICs in the form of Participating Securities.^{5/} Participating Securities have prioritized payments (at the rate of 10-year treasuries) and a profit participation, both of which are payable only if and when the SBIC generates profits. The Participating Securities are structured as preferred limited partnership interests in traditional venture capital limited partnerships and have maturities of up to 10 years.^{6/}

Liberty Fund will be governed by a limited partnership agreement (the "Partnership Agreement"). A copy of the Partnership Agreement appears as Exhibit A to the accompanying Form N-2. Under the Partnership Agreement, the managing general partner ("Managing General Partner") of Liberty Fund will select its portfolio securities and operate Liberty Fund on a day-to-day basis. In addition, two natural persons will serve as individual general partners ("Individual General Partners") and will perform the duties of disinterested directors in accordance with Section 56 of the 1940 Act.

As permitted by Section 302 of the Delaware Revised Limited Partnership Act, the Partnership Agreement provides the holders of Units with limited voting rights on certain matters, including the following; (1) the power

^{5/} 15 U.S.C. § 683(g) (1994 Supp.).

^{6/} 59 Fed. Reg. 16917 (Apr. 8, 1994) (adding definition of "Participating Securities" to 13 C.F.R. 107.3); 59 Fed. Reg. 16924 (Apr. 8, 1994) (adding 13 C.F.R. § 107.241(g)).

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to consent to the admission of, or approve and elect, as the case may be, successor and additional Individual General Partners under certain circumstances; (2) the power to consent to the admission of a successor Managing General Partner in the event of withdrawal or removal of the Managing General Partner; (3) the power to approve and elect a successor Managing General Partner in the event of the incapacity of the Managing General Partner; and (4) the power to propose and approve certain amendments to the Partnership Agreement.^{7/}

The provisions of the Partnership Agreement pertaining to Participating Securities are set forth in SBA Annex PS (the "SBA Annex") which is in the form contained in the SBIC Applicant's Kit furnished by the SBA to prospective licensees and which the SBA recommends be adopted by the applicant as part of its Limited Partnership Agreement. The SBA Annex does not provide the holders of Participating Securities with voting rights of the types described above which are available to holders of the Units.

The SBA has substantial regulatory authority over Liberty Fund under the SBIA which eliminates the need for the SBA to have voting rights as a limited partner. For example, there can be no transfer of control of an SBIC without SBA approval.^{8/} An SBIC issuing Participating Securities must consent in its organizing documents to a variety of remedies available to the SBA, including (a) the SBA's right to remove the SBIC's officers, directors or general partners and/or the SBA's right to appoint a receiver (these remedies may be exercised by way of example for insolvency, extreme capital impairment, transfer of control, fraud or fraudulent transfers);^{9/} (b) the SBA's right to replace officers and a majority of the directors of a corporate SBIC or to remove general partners of an unincorporated licensee and to replace them with general partners

^{7/} See Section 5.04 of the Partnership Agreement.

^{8/} 13 C.F.R. § 107.104; 13 C.F.R. § 601, as amended in 59 Fed. Reg. 16949 (Apr. 8, 1994).

^{9/} 59 Fed. Reg. 16932 (Apr. 8, 1994) (adding 13 C.F.R. § 107.262(b)).

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approved by the SBA (these remedies may be exercised by way of example for willful conflicts of interest, willful and repeated noncompliance, and failure to comply with other restrictions);^{10/} and (c) the SBA's right to restrict the operations of the SBIC (these remedies may be exercised by way of example for failure to maintain regulatory capital, capital or liquidity impairment, improper distributions, excessive management fees or expenses, failure to maintain diversity between management and ownership, and failure to maintain required investment ratios).^{11/}

DISCUSSION

Section 61(a) of the 1940 Act makes Section 18 applicable to a BDC to the same extent as if it were registered as a closed-end investment company, except as modified by Sections 61(a)(1) through 61(a)(4). Section 18(i), which is not modified by Sections 61(a)(1) through 61(a)(4), states, in part, that except as "otherwise required by law, every share of stock issued by a registered management investment company . . . shall be a voting stock and have equal voting rights with every other voting stock" The question raised by the facts set forth above is whether the structure of Liberty Fund and the SBA regulatory environment in which it will operate will comply with Section 18(i). Based on the analysis set forth below, we believe that the requirements of Section 18(i) as applied by the Commission have been met and that the staff should grant the requested relief.

The 1940 Act does not define "equal voting rights," and the legislative history does not discuss the meaning of this term. In its opinion captioned In the Matter of the Solvay American Corporation ("Solvay"),^{12/} the Commission acknowledged that "in the absence of any definition or of any discussion at the Congressional hearings [relating to the enactment of the Act]

^{10/} 59 Fed. Reg. 16932 (Apr. 8, 1994) (adding 13 C.F.R. § 107.262(c)).

^{11/} 59 Fed. Reg. 16932-16933 (Apr. 8, 1994) (adding 13 C.F.R. § 107.262(d)).

^{12/} See Solvay American Corporation, 27 S.E.C. 971, 973 (April 12, 1943).

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with regard to the meaning of the 'equal voting rights' requirement, we must rely on the general purposes of the statute to determine whether [such requirement is met]." The Commission stated that "an inflexible adherence to any rigid interpretation [of such requirement] could produce grave distortions of the apparent intent of congress . . . and that each individual case must be decided on the particular facts involved."^{13/} In Solvay, the Commission concluded that, even though the holders of preferred stock had the right, as a separate class, to elect certain directors and to vote on "matters of particular interest to the preferred stockholders," the voting provisions of Solvay's two classes of stock did not violate the standards of the Act. In Solvay then, the Commission established a principle of reasonableness for determining the meaning of "equal voting rights" within the context of Section 18(i). Following the Commission's direction, the staff has shown considerable flexibility in granting no-action relief under Section 18(i). We believe that the basis for granting relief in Liberty Fund's case is equally, if not more, compelling.

The rights associated with the Participating Securities have been established by the SBA in the form of the SBA Annex which is incorporated as a part of the Partnership Agreement. Although the Participating Securities do not have the right to vote on partnership matters in a manner that is identical to the limited voting rights of the holders of Units, SBA regulatory oversight or approval will be required with respect to proposed action by the partnership in a number of significant areas discussed above. In many instances these oversight and approval rights are substantially greater than the limited voting rights granted to holders of Units by the Partnership Agreement. The staff of the Commission on a number of occasions has followed the Commission's mandate of flexibility in granting no-action relief where the differences relate to the "particular interest" of the preferred holder,^{14/} in this case the SBA.

^{13/} Id. at 974 n. 9.

^{14/} See Sentinel Group Funds, Inc. (pub. avail. Oct. 27, 1992); Drexel Burnham Lambert, Inc. (TARPS) pub. avail. June 14, 1989); Allstate Municipal Premium Income Trust (pub. avail July 14, 1989); Zenith Income Fund, Inc. (pub. avail. Apr. 27, 1988)

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Further in those instances where the oversight and approval rights under the rules and regulations of the SBA benefit the Participating Securities and extend beyond the limited voting rights of the holders of the Units, Section 18(i) of the 1940 Act would permit such result as a matter "otherwise required by law."

The requested relief also will enable Liberty Fund to implement an important component of the 1992 Amendments -- the issuance of Participating Securities. Accordingly, for the foregoing reasons, we request the staff's assurance that it will not recommend enforcement action under Section 18(i) if Liberty Fund issues the Participating Securities. Please contact the undersigned or Lawrence Stadulis at (202) 467-7405 if you have any questions concerning this matter.

Sincerely,



John F. Bales, III



U.S. SMALL BUSINESS ADMINISTRATION
WASHINGTON, D.C. 20416



DEC 15 1984

Exhibit A

Mr. Thomas R. Morse
Philadelphia Ventures Fund, L.P.
The Bellevue
200 South Broad Street
Philadelphia, PA 19102

Re: Philadelphia Ventures Liberty Fund, L.P.

We are writing this letter in conjunction with the request of counsel to Philadelphia Ventures Liberty Fund, L.P. (the "Fund") for a no action letter with respect to the application of Section 18(i) of the Investment Company Act of 1940, as amended (the "1940 Act"), to the preferred limited partnership interests which the Fund proposes to issue.

The Fund, organized as a Delaware limited partnership, has applied to the U.S. Small Business Administration (the "SBA") for a license to operate as a small business investment company ("SBIC") under the Small Business Act of 1958, as amended, and the rules and regulations promulgated thereunder (the "SBIC Act"). You have advised us that the Fund will be organized as a business development company under the 1940 Act.

You have further advised us that, upon licensing as an SBIC, the Fund intends to apply for Leverage from the SBA exclusively in the form of Participating Securities. As a consequence, the Fund will issue preferred limited partnership interests to the SBA each time that Leverage is taken down by the Fund. That is, in return for funding from the SBA, the Fund will issue to the SBA limited partnership interests. These interests, known as preferred limited partnership interests, will be different than the limited partnership interests issued to the other limited partners. The preferred limited partnership interests will be entitled to receive a Prioritized Payment and a Profit Participation, the amounts of which are dependent on the amount of Earmarked Profits of the SBIC. The Original Issue Price of the Participating Security less prior prepayments plus other amounts earned but not paid (such as the Prioritized Payments) have a priority in liquidation over other partnership interests of the Fund.

The Small Business Credit and Business Opportunity Enhancement Act of 1992 (the "1992 Act"), which created Participating Securities, and SBA's implementing regulations, set forth the characteristics of Participating Securities. These do not include any requirement that these securities have voting rights. In addition, the SBA has published forms containing model partnership provisions for SBIC applicants intending to issue Participating Securities. These forms do not contain any Provisions with respect to voting of those interests.

The SBA had determined that neither the authorizing legislation nor its underlying policy require that Participating Securities be voting securities and have, on the contrary, concluded that Participating Securities should not be voting securities. As a consequence, the organizational documents of an SBIC (whether they are the articles of incorporation for a corporate SBIC or the limited partnership agreement for a limited partnership SBIC) will not contain voting provisions for Participating Securities, and the SBA will not license applicants who seek to confer voting rights on the SBA. One reason for this position is that the SBA does not wish to increase the likelihood that it may incur liability to third parties if it exercises voting rights.

The SBA believes its rights are protected by a comprehensive regulatory framework. For example, the sole purpose of an SBIC must be to operate as an SBIC under the SBIC Act, and, if the SBIC is organized as a limited partnership, its entity general partner must operate solely as that general partner. The SBA must approve the general partner(s) of the limited partnership. Transfer of control of an SBIC is prohibited without prior SBA approval. The SBA has remedial rights where the SBIC fails to meet regulatory standards, including the right to remove general partners or appoint a receiver or to restrict the SBIC's operations.

We have no objection if the Fund shares this letter with the staff of the Securities and Exchange Commission in connection with the Fund's no action letter request. In that regard it is offered only as an indication of SBA's position on the lack of voting rights associated with Participating Securities.

We are available to discuss this matter and related issues with you or the Staff of the Securities and Exchange Commission, if that would be useful.

Sincerely,



Robert D. Stillman
Associate Administrator
for Investment