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Nancy M. Morris, Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

RE: Comments Regarding Proposed Rule 206(4)-8 Under the Investment Advisers Act of 1940 and Proposed Rules 509 and 216 Under Regulation D (File No. S7-25-06)

Ladies and Gentlemen:

This letter is submitted by the Committee on Federal Regulation of Securities (the "Committee"), Section of Business Law (the "Section") of the American Bar Association (the "ABA") in response to a request for comment by the staff ("Staff") of the U.S. Securities and Exchange Commission (the "Commission") on proposed Rule 206(4)-8 under the Investment Advisers Act of 1940 (the "Advisers Act") and proposed Rules 509 and 216 under the Securities Act of 1933 (the "Securities Act") described in Release No. 33-8766 and No. IA-2576 disseminated for public comment on December 27, 2006 (the "Proposing Release"). This letter has been prepared by members of the Subcommittee on Private Investment Entities (the "Subcommittee").

The comments expressed in this letter have not been approved by the House of Delegates or Board of Governors of the ABA and, therefore, do not represent the official position of the ABA. In addition, this letter does not represent the official position of the Section (or any other ABA Section), the Committee or the Subcommittee, and does not necessarily reflect the views of the Committee and Subcommittee members who have reviewed it.

I. PROPOSED RULE 206(4)-8 UNDER THE ADVISERS ACT

As proposed, Rule 206(4)-8 under the Advisers Act would make it a fraudulent, deceptive, or manipulative act, practice, or course of business within the meaning of Section 206(4) of the Advisers Act for an investment adviser (whether registered or unregistered) of a "pooled investment vehicle" to make any false or misleading statement of material fact or to otherwise defraud any investor or prospective investor in a pooled investment vehicle.[1]

Issue 1: The Commission's Rulemaking Authority. The Commission has introduced proposed Rule 206(4)-8 in the aftermath of the D.C. Circuit's decision in Goldstein v. SEC, 451 F.3d 873 (D.C. Cir. 2006), which the Commission believes "created some uncertainty regarding the application of Sections 206(1) and 206(2)

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[1] Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles, Securities Act Release No. 8766, Accredited Investors in Certain Private Investment Vehicles, Investment Company Act Release No. 2576, 72 Fed. Reg. 400, 417 (proposed January 4, 2007) (to be codified at 17 C.F.R. pts 230 and 275 (hereinafter "Proposing Release") at 417.

of the Advisers Act in certain cases where investors in a pool are defrauded by an investment adviser."[2] The Commission contends that Section 206(4) is broader in scope than Sections 206(1) and 206(2) and is not limited to prohibiting conduct aimed at "clients" or "prospective clients". Section 206(4) grants the Commission the authority to, by "rules and regulations define, and prescribe means reasonably designed to prevent, such acts, practices, and courses of business as are fraudulent, deceptive, or manipulative."[3] The Commission believes that such authority enables it to introduce proposed Rule 206(4)-8 to protect investors and prospective investors in pooled investment vehicles from fraud.

Response: We share the Commission's concerns regarding fraud and acknowledge that the Commission is attempting, by the proposed rulemaking under Rule 206(4), to reassert the positions it took before the Goldstein decision under Sections 206(1) and 206(2) with respect to the protection of investors in private investment pools. However, we are concerned that the grant of rulemaking authority under Section 206(4) is not broad enough to encompass the Commission's objective because, as noted above, the enabling provision of Section 206(4) grants to the Commission *only* the authority to "*define*, and prescribe means reasonably designed to prevent, such acts, practices, and courses of business as are fraudulent, deceptive, or manipulative." Even if proposed Rule 206(4)-8(a)(1) adequately defines what constitutes fraud under Section 206(4) (see discussion below), we do not believe that proposed Rule 206(4)-8(a)(2) in any way *defines* "acts, practices, and courses of business as are fraudulent, deceptive, or manipulative."

We note that all of the other rules promulgated under Section 206(4) *define,* with specificity, prohibited conduct that constitutes a fraudulent, deceptive, or manipulative act, practice, or course of business in the context of advertising,[4] custody of funds,[5] cash payments for client solicitations,[6] financial and disciplinary disclosure by the investment adviser,[7] proxy voting,[8] and compliance procedures.[9] These are the types of rules Congress intended when it gave the Commission the authority under Section 206(4) to provide advisers with concrete guidance as to what constitutes fraudulent, deceptive, and manipulative behavior.

Enabling provisions substantially similar to those found in Section 206(4) are found in Sections 14(e)[10] and 15(c)(2)[11] of the Securities Exchange Act of 1934 (the "Exchange Act"). The rules adopted by the

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[2] Id. at 401.

[3] 15 U.S.C. § 80b-6(4).

[4] 17 C.F.R. § 275.206(4)-1.

[5] 17 C.F.R. § 275.206(4)-2.

[6] 17 C.F.R. § 275.206(4)-3.

[7] 17 C.F.R. § 275.206(4)-4.

[8] 17 C.F.R. § 275.206(4)-6.

[9] 17 C.F.R. § 275.206(4)-7.

[10] "It shall be unlawful for any person to make any untrue statement of a material fact or omit to state any material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading, or to engage in any fraudulent, deceptive, or manipulative acts or practices, in connection with any tender offer or request or invitation for tenders, or any solicitation of security holders in opposition to or in favor of any such offer, request, or invitation. The Commission shall, for the purposes of this subsection, by rules and regulations define, and prescribe means reasonably designed to prevent, such acts and practices as are fraudulent, deceptive, or manipulative."

[11] "No broker or dealer shall make use of the mails or any means or instrumentality of interstate commerce to effect any transaction in, or to induce or attempt to induce the purchase or sale of, any security (other than an exempted security or commercial paper, bankers' acceptances, or commercial bills) otherwise than on a national securities exchange of which it is a member, in connection with which such broker or dealer engages in any fraudulent, deceptive, or manipulative act or practice, or makes any fictitious quotation…The Commission shall, for the purposes of this paragraph, by rules and regulations define, and prescribe means reasonably designed to prevent, such acts and practices as are fraudulent, deceptive, or manipulative and such quotations as are fictitious."

Commission under both of those sections reflect the same type of specificity found in Rules 206(4)-1 through 206(4)-7 promulgated under Section 206(4).[12] In each case, the Commission has used the statutory authority to define and prescribe conduct with the specificity required to provide advisers, with regard to the rules under Section 206(4), and the persons covered by Exchange Act Sections 14(e) and 15(c)(2), with regard to the rules under those sections, with notice of prohibited conduct and to allow them to conform their practices accordingly.

This specificity is absent in proposed Rule 206(4)-8. Proposed Rule 206(4)-8(a)(2) fails to identify any delineated conduct that would constitute fraudulent, deceptive, or manipulative behavior. As noted above, we are concerned whether proposed Rule 206(4)-8(a)(1) falls within the statutory authority granted to the Commission by Section 206(4) and whether the proscription not to "make any untrue statement of a material fact or omit to state a material fact…" defines with sufficient specificity conduct that is fraudulent, deceptive, or manipulative. While this language is similar to other provisions contained in the securities laws (such as Rule 10b-5 under the Exchange Act), we believe that the Commission's position that scienter is not required under proposed Rule 206(4)-8 is a determining factor (see Issue 2 below) in concluding that the proposed rule falls beyond the authority granted by Section 206(4).

We also believe that fraud in the absence of scienter is a concept that should not be expanded. Although we anticipate that the Commission and its Staff, as an enforcement matter, would generally only enforce the proposed rule where scienter is present, we also believe that the authority to bring an action where there is no scienter is unnecessary and ill-advised. Making undefined, unintentional material omissions or misstatements fraudulent in the context of the entire adviser-investor relationship will undoubtedly "chill" communications between the investment adviser and fund investors. We are concerned that the Commission's desire to enhance hedge fund transparency will suffer substantially if the proposed rule is adopted in its current form.

Issue 2: **Scienter**. In the Proposing Release, the Commission states that, unlike Rule 10b-5 under the Exchange Act, the Commission would not be required to demonstrate that an adviser violating proposed Rule 206(4)-8 acted with scienter. To support this assertion, the Commission cites to the decision in SEC v. Steadman,[13] in which the D.C. Circuit analogized the wording of Section 206(4) of the Advisers Act to that found in Section 17(a)(3) of the Securities Act[14] which the Supreme Court, in Aaron v. SEC,[15] held does not require a showing of scienter to establish liability. The Commission has requested comment on this provision of the proposed rule.

Response: We believe that the language "prescribe means reasonably designed to prevent…[fraud]" does not expand the Commission's authority to "define" fraud. That language gives the Commission rulemaking power to prescribe rules to prevent fraud, not to expand the concept of fraud itself beyond its original meaning, which is not negligent conduct, but instead, conduct that has some element of scienter or deliberateness. We acknowledge that Steadman supports the proposition that scienter need not be an element of a violation of the rules promulgated under Section 206(4). In our judgment, however, the Steadman decision is

[12] Rules under Section 14(e) address fraudulent conduct in connection with: (a) tender offer practices (Rule 14e-1); (b) disclosure requirements for subject companies (Rule 14e-2); (c) insider trading on information concerning tender offers (Rule 14e-3); (d) partial tender offers (Rule 14e-4); (e) purchases outside of a tender offer (Rule 14e-5); (f) repurchases by certain closed-end registered investment companies (Rule 14e-6); (g) roll-ups (Rule 14e-7); and (h) pre-commencement communications (Rule 14e-8).

Rules under Section 15(c)(2) address fraudulent conduct in connection with: (a) hypothecation of customer securities (Rule 15c2-1); (b) payments in connection with underwritings (Rule 15c2-4); (c) extending or arranging credit in certain transactions (Rule 15c-5); (d) modification of quotations (Rule 15c2-7); (e) delivery of prospectuses (Rule 15c2-8); (f) quotations without specified information (Rule 15c2-11); and (g) municipal securities disclosures (Rule 15c2-12).

[13] 967 F.2d 636 (D.C. Cir. 1992).

[14] Id. at 647.

[15] 446 U.S. 680 (1980).

inconsistent with a reading of related statutes and cases which compel the conclusion that scienter is required under Section 206(4) and, therefore, should be required in proposed Rule 206(4)-8.

First, Section 206(4) of the Advisers Act and Section 17(a)(3) of the Securities Act are markedly different. The Supreme Court in Aaron, interpreting Section 17(a)(3), stated:

> "[T]he language of § 17(a)(3), under which it is unlawful for any person "to engage in any transaction, practice, or course of business which *operates* or *would operate* as a fraud or deceit," quite plainly focuses upon the *effect* of particular conduct on members of the investing public, rather than upon the culpability of the person responsible. This reading follows directly from [SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180 (1963)], which attributed to a similarly worded provision in § 206(2) of the [Advisers Act] a meaning that does not require a "showing [of] deliberate dishonesty as a condition precedent to protecting investors." 375 U.S. at 200."[16]

As the Aaron court noted, the key language "operates or would operate as a fraud or deceit" is very similar to that found in Section 206(2) of the Advisers Act and focuses on the *effect* of the person's conduct on others, not on the state of mind of the actor, and thus, no showing of scienter is required to establish liability. The Steadman court relied on this logic in determining that no scienter was required to establish liability under Section 206(4). However, the wording of Section 206(4) and Section 17(a)(3) (and Section 206(2)) are not comparable. Section 206(4) does not contain the "operates as" language, and therefore cannot be said to focus on the effect of conduct. Section 206(4) prohibits conduct that "*is* fraudulent, deceptive, or manipulative" (emphasis added) and focuses on whether the investment adviser is culpable on the basis of engaging in conduct that is "fraudulent, deceptive or manipulative."

Furthermore, the fact that a practice or course of business "operates" as a fraud is distinguishable from a practice or course of business that "is" itself a fraud. The former is much more inclusive as the practice or course of business itself may not necessarily itself be a fraud.[17] Section 206(4) requires that the conduct at issue "is" a fraud – the section prohibits "engaging in any act, practice, or course of business which is fraudulent, deceptive, or manipulative." Requiring that the conduct at issue be "fraudulent, deceptive, or manipulative" indicates that the conduct must be accompanied by a culpable mental state.

Another important distinction between Section 206(4) and Section 17(a)(3) is that the term "manipulative" is included in Section 206(4), but is not a part of Section 17(a)(3). The use of the term "manipulative" denotes Congress' desire to punish conduct that is designed to deceive or defraud. The Supreme Court on several occasions has read the term "manipulative" to indicate that the actor must act with intent or knowledge.[18] The Supreme Court, in Ernst & Ernst v. Hochfelder, specifically stressed that the "[u]se of the word "manipulative" is especially significant."[19] In Schreiber v. Burlington Northern, Inc., the Supreme Court noted the textual similarity between Section 14(e) of the Exchange Act (which requires a showing of scienter) and Section 206, and held that the term "manipulative" as used in Section 14(e) "connotes 'conduct designed to deceive or defraud investors by controlling or artificially affecting the price of securities.'"[20] These cases clearly support the conclusion that the presence of the term "manipulative" in Section 206(4) evidences Congressional intent to punish only conduct in which the actor engaged with a culpable mental state or engaged in activities *intended* to deceive or defraud investors.

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[16] Id. (emphasis in original).

[17] Norman B. Arnoff and Stephen B. Wexler, Investment Advisor Sanctions: Three-Tier Sanction Scheme, N.Y.L.J. 4, (col. 4) (Tuesday, September 5, 2006).

[18] Aaron, at 694 (in the context of Rule 10b-5 of the Exchange Act).

[19] Ernst & Ernst v. Hochfelder, 425 U.S. 185, 199 (1976) (in the context of Rule 10b-5 of the Exchange Act).

[20] Schrieber v. Burlington Northern, Inc., 472 U.S. 1, 11-12 (1985) (quoting Hochfelder, 425 U.S. at 199) (emphasis in original).

Additionally, we believe the Steadman court should not have analogized Section 206(4) to Section 17(a)(3) because the latter applies only to the offer and sale of securities while the former applies to all activities of the investment adviser.

For the reasons stated above, we believe that Section 206(4) requires a showing of scienter to establish liability. Accordingly, we respectfully disagree with the Commission's assertion that proposed Rule 206(4)-8 should not require a showing of scienter to establish liability.

Issue 3: Advisers to Registered Investment Companies. In the Proposing Release, the Commission notes that the term "pooled investment vehicle" would be defined in proposed Rule 206(4)-8(b) to encompass both investment companies as defined in Section 3(a) of the Company Act and investment pools excluded from the definition of an investment company by Section 3(c)(1) or 3(c)(7) of the Company Act. The Commission acknowledges that the proposed rule would not distinguish among types of pooled investment vehicles. The Commission has requested comment on the appropriate scope of the rule and, if commenters suggest limiting coverage of the proposed rule, they should provide an explanation for why proposed distinctions should be drawn.[21]

Response: We believe that investment companies as defined in Section 3(a) of the Company Act should be excluded from the coverage of the proposed rule because the Commission already has an arsenal of enforcement tools at its disposal with respect to those who defraud investment companies.

As we noted earlier, a principal goal of the Commission in proposing Rule 206(4)-8 was to fill a perceived regulatory gap created by the Goldstein decision. This gap is similar to the regulatory gap that the Commission sought to fill in 2004 when it adopted a revised definition of "client" for purpose of determining when investment advisers had to register under Section 203 of the Advisers Act.[22] The issue that the Commission sought to address in 2004 – that advisers of "private funds" were not regulated – is not at issue with respect to advisers to registered investment companies.

Advisers to registered investment companies must register under the Advisers Act. Moreover, the Company Act provides a substantial level of investor and market participant protection. The Company Act also provides a historical record of interpretation and enforcement of its provisions, as applied to investment companies and their advisers, and covers not only fiduciary and operational standards, but also how particular conflicts must be handled. Provisions under the Company Act and the Commission's rules thereunder already require advisers to identify and resolve conflicts of interest that may arise between an adviser and its clients, and in many cases, adopt and follow extensive procedures designed to ensure that investor interests come first.

Proposed Rule 206(4)-8 purports to address two major types of conduct – false and misleading statements and other types of fraud. With respect to the first category, the proposed rule is unnecessary for registered investment companies. Section 34(b) of the Company Act (as well as the anti-fraud provisions of the Securities Act and Exchange Act relating to offerings of securities, proxy statements and periodic reports) already covers much of the ground that proposed Rule 206(4)-8 would cover. In particular, Section 34(b) prohibits "any person" from making misstatements or omissions in registration statements, applications and reports, and in accounts and records of a registered fund.[23] Section 34(b) liability does not require a purchase or sale, nor does it

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[21] Proposing Release at 402.

[22] Registration under the Advisers Act of Certain Hedge Fund Advisers, Investment Advisers Act Release No. 2333 (Dec. 2, 2004).

[23] Section 34(b)'s prohibition applies to registration statements, applications, reports, accounts, records or other documents filed or transmitted pursuant to the Company Act, or the keeping of which is required by Section 31(a) of the Company Act. Section 31(a) of the Company Act requires a fund to maintain particular records identified by the SEC in rules under Section 31. Rule 31a-1 defines the scope of this record-keeping provision and in sum, requires funds to preserve most, if not all, records that would be used by the fund or adviser in the operation of its business, including the operating records of the fund, and any communications, reports or other filings through which the fund or the adviser communicates with investors. Thus, the Company Act already provides the protection proposed Rule 206(4)-8 would add, and Section 34 applies to statements or omissions by any person. In other words, it applies to all service providers of a fund, not only to its adviser.

require a "statement" to investors. For mutual funds, Section 34(b) already covers much of the ground that the proposed rule attempts to cover. Accordingly, proposed Rule 206(4)-8 is not necessary to protect such investors or market participants.

With respect to other forms of potentially problematic conduct, other provisions of the Company Act provide ample plenary protections to mutual fund investors. For example, Section 17, one of the core provisions of the Company Act, prohibits investment advisers and other affiliated persons from engaging in a broad range of transactions with or involving registered investment companies. The proposed anti-fraud rule is unnecessary to provide the Commission with the jurisdiction to proceed against investment advisers that violate these core provisions. Similarly, the Company Act and the rules thereunder address other core issues, such as the valuation of fund assets,[24] and provide the Commission with plenary authority to proceed against investment advisers to registered investment companies for breaches of fiduciary duties involving personal misconduct.[25]

An argument could be made that the proposed rule would allow the Commission to proceed against advisers to registered investment companies without involving the advised funds themselves. We believe, however, that any such actions of necessity would involve the funds, because the allegedly misleading statements would appear in a fund document or filing.[26]

Including advisers to registered investment companies within the coverage of proposed Rule 206(4)-8 would add considerable confusion to the mix of standards that govern the conduct of investment companies and their advisers. There already exists a substantial body of law interpreting the standards for conduct and disclosure under the Securities Act, the Exchange Act and the Company Act. Without modification, proposed Rule 206(4)-8 would introduce another standard of undefined behavior that would potentially conflict with the standards already in place under these other securities laws, making it more, not less, difficult to combat fraud at this level.[27]

II. PROPOSED RULES 509 AND 216

The Commission proposes to adopt a new category of accredited investor called an "accredited natural person". The heightened standard is designed to supplement existing requirements under Rule 501 under Regulation D and under Section 4(6) of the Securities Act to identify those natural persons who are likely to have sufficient knowledge and financial sophistication to evaluate the merits of a prospective investment in a private investment vehicle and to bear the economic risk of such an investment.

Proposed Rules 509 and 216 would define "accredited natural person" as any natural person who meets either the net worth (in excess of $1 million individually or jointly with a spouse) or income (in excess of $200,000 for the two most recent years with a reasonable expectation of $200,000 in the year in which the investment is made or in excess of $300,000 jointly with a spouse) test <u>and</u> who owns at least $2.5 million in qualifying investments. The accredited natural person standard would apply only to investors in "private investment

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[24] Section 22 and the rules thereunder require mutual funds to sell shares at net asset value per share subject to loads; Section 23 regulates the price at which shares of closed-end investment companies may be sold and the manner in which they may be repurchased; and other provisions require funds to adopt and comply with valuation policies intended to ensure that assets are valued accurately and consistently.

[25] 15 U.S.C. § 80a-36.

[26] It could be argued that a misleading statement could be made in an account statement that does not involve a fund. Given the other enforcement tools available to the Commission, we believe that the uncertainties created by the proposed rule far outweigh the benefit that the proposed rule would provide to the Commission, particularly in light of our views on the scienter issue.

[27] We also note that certain hedge funds and funds of funds which undertake to register as investment companies pursuant to the Company Act have been required by the Commission, through the registration process, to limit investors either to persons (a) who are advised by a registered investment adviser or (b) who are accredited investors. Because such funds are registered under the Company Act, and have advisers registered under the Advisers Act, we urge the Commission to abandon this informal practice.

vehicles" that rely on the exclusion from the definition of an investment company provided by Section 3(c)(1) of the Company Act.[28]

Issue 1: General Comment. The Commission has made a general request for comment on proposed Rules 509 and 216.

Response: We recognize that the President's Working Group, in its "Agreement on Principles and Guidelines regarding Private Pools of Capital" released on February 22, 2007, endorsed the principle that investor protection concerns may be addressed through market discipline and regulatory policies that limit investment in such pools to more sophisticated investors. We are concerned, however, that the strict qualification standards contained in the proposed rules would inhibit the formation of new hedge and private equity funds utilizing the safe harbor provided by Regulation D and the Section 3(c)(1) exclusion from the definition of an investment company.

We are mindful that Section 3(c)(1) itself does not require that the beneficial owners of a private investment vehicle satisfy any financial requirements. To qualify for the Section 3(c)(1) exclusion, the fund must engage in a private offering. Prior to 1982, issuers relied upon Section 4(2) of the Securities Act to qualify their offerings as private offerings of their securities.[29] Section 4(2) also did not (and does not) contain any financial requirements. It was not until the Commission adopted the Regulation D safe harbor in 1982 that issuers began to solicit information about net income and/or net worth to determine if a prospective investor would qualify as an accredited investor. Our concern is that issuers relying upon the Section 3(c)(1) exclusion will find that they cannot find a sufficient number of "accredited natural persons" and therefore will return to pre-1982 practices and seek to effect private placements pursuant to Section 4(2) without utilizing Regulation D. As the Proposing Release recognizes, this result is not necessarily desirable for the issuer because of the difficulties involved,[30] and it is not necessarily desirable for the Commission as the information the Commission receives concerning Regulation D offerings through filings of Form D may, as a consequence, diminish.[31]

We recognize that this result may be unavoidable if the Commission adopts the requirement that individuals have $2.5 million in investments to qualify as an accredited natural person, or even a lesser amount. As a consequence, if the Commission adopts the accredited natural person requirement, we recommend that the Commission exempt from proposed Rules 509 and 216, Section 3(c)(1) pools that are advised by registered investment advisers. As most Section 3(c)(1) pools charge a performance-based fee to their investors, the investors in such pools advised by registered advisers would need to be "qualified clients" as defined in Rule 205-3 of the Advisers Act for the adviser to charge the investor a performance-based fee. Rule 205-3 defines a "qualified client" as an investor with a net worth of at least $1.5 million (for unaffiliated investors) or investors who have $750,000 under management with the adviser. The "qualified client" standard is less onerous than the proposed $2.5 million investments test, but it would only be available to funds with registered investment advisers.

This proposal would provide an incentive for investment advisers to register with the Commission under the Advisers Act, although admittedly not all advisers would qualify to register as some advisers may not have at least $25 million in assets under management. A second benefit of this approach is that it would, in effect, restore

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[28] 15 U.S.C. § 80a-3(c)(1)(A), (B) (2004). The following person is not an investment company:

> Any issuer whose outstanding securities (other than short-term paper) are beneficially owned by not more than one hundred persons and which is not making and does not presently propose to make a public offering of its securities. Id.

[29] 15 U.S.C. § 77(d)(2).

[30] Difficulties for the issuer would include the expense and complication of multi-state securities law compliance, which is unnecessary for transactions complying with Rule 506, because of the federal preemption of state securities laws under Section 18(b)(4)(D) of the Securities Act.

[31] Without commenting on the continuing utility of Form D, to have a better census of funds formed under Section 3(c)(1), the Commission could consider amending Form D to indicate whether the issuer is utilizing the Section 3(c)(1) or 3(c)(7) exclusion and, if so, whether it is a hedge fund, private equity fund or venture capital fund and whether the adviser to the fund is registered.

the status quo prior to the Goldstein decision. Section 3(c)(1) pools would either: (a) have registered investment advisers, in which case the current Regulation D standards would apply to investors; or (b) be required to comply with proposed Rules 509 and 216.

Issue 2: $2.5 Million Investment Test. The Commission has stated that adding a new requirement that natural persons have $2.5 million in investments to invest in a private investment vehicle is appropriate given the effects of inflation, the rise in the value of personal residences, and the increasing complexity of financial products.[32]

Response: We believe that updating the qualification standards originally adopted in 1982 is appropriate and commend the Commission's efforts in this regard. We also believe that to the extent a dollar standard can be used as a proxy for investor sophistication, we do not have the expertise to approve or critique the test proposed by the Commission. We do believe that a standard based on investments (as opposed to net worth) is a better proxy for sophistication in making investments.

In the Commission's final release on Regulation D, it noted that the net worth test was originally set at $750,000, but the Commission, "for simplicity," ultimately increased the amount by $250,000 to reflect the value of certain assets, namely primary residences.[33] Because the proposed rules would exclude from the definition of "investments" real estate used as a personal residence or a place of business, it would be more appropriate, therefore, to calculate the inflation rate based on $750,000 of net worth (i.e., without considering primary residences), rather than $1 million. Based on the levels used by the Commission's Office of Economic Analysis, which found that the 1982 Regulation D $1 million net worth amount would be $1.9 million as of July 1, 2006, the current value of $750,000 would be $1.425 million. Therefore, we believe that a threshold of $1.5 million is more consistent with the notion of adjusting the standards set in 1982 for inflation. We are not aware of what percentage of households would qualify if the standard was set at $1.5 million in investments.

We note that the $2.5 million investment test raises the bar much more than an inflation adjustment from the $1 million test established in 1982. Accordingly, we would not endorse a continuing inflation adjustment every five years. We suggest the Commission omit such an automatic adjustment and use the rulemaking process to make adjustments if it finds, after experience with the accredited natural person standard, that such adjustments are necessary. This is the position the Commission took in 1998 when it raised the Rule 205-3 qualified client net worth test from $1 million to $1.5 million.

Issue 3: Grandfathering of Existing Accredited Investors. The Commission notes in the Proposing Release that the proposed rules would not grandfather current accredited investors who would not meet the new accredited natural person standard so they could make future investments in private investment pools, even those in which they are currently invested. The Commission has requested comment on whether such treatment is appropriate.[34]

Response: We recommend that the Commission grandfather current accredited investors so that existing investors in Section 3(c)(1) funds should be permitted to make additional investments in private pools in which they are already invested. Such investors have existing relationships with the advisers of investment pools in which they are already invested and are likely to have access to important information concerning the investment pool's operations and risk management processes, which allow existing investors to make informed investment decisions about additional investments in the investment pool. In addition, it is critical to a pool's operation that employees who are existing investors be able to continue to invest even if they do not meet the accredited natural person standard. Also, certain investors would be disadvantaged if they were unable to purchase additional interests

[32] Proposing Release at 406.

[33] Revision of Certain Exemptions from Registration under the Securities Act of 1933 for Transactions Involving Limited Offers and Sales, Securities Release No. 6389, 17 Fed. Reg. 230 and 239 (March 8, 1982)("The Commission proposed a level of $750,000 for this test. Some commentators, however, recommended excluding certain assets such as principal residences and automobiles from the computation of net worth. For simplicity, the Commission has determined that it is appropriate to increase the level to $1,000,000 without exclusions").

[34] Proposing Release at 406.

in funds in which they are already invested because their investments may be diluted by the issuance of additional interests to other investors.

When the Commission adopted the Section 3(c)(7) exclusion from the Company Act, existing investors in Section 3(c)(1) funds converting to Section 3(c)(7) funds were permitted to continue investing money in the grandfathered funds. We see no reason why existing investors in Section 3(c)(1) funds should be treated any differently under the proposed rules.

We also believe that if the fund's governing documents permit the investor to reinvest his or her fund profits (whether automatically without any action on the part of the investor or with the affirmative action of the investor), the investor should be able to do so, regardless of whether the investor at such time meets the accredited natural person standard. Because the investor has already contributed the capital to the fund, he or she should be permitted to reinvest the profits earned on such capital.

The term "private investment vehicle," as defined, would include both funds that permit investors to redeem or withdraw (and reinvest) their capital and funds where investors commit capital to the fund which is drawn down by the general partner of the fund when investment opportunities arise--such as a typical private equity fund. We expect the Commission does not intend that, with respect to a fund that has relied on Section 3(c)(1) where investors have committed to invest capital over a period of time in accordance with the governing documents of the fund, an investor who does not meet the new accredited natural person standard would not then be permitted to satisfy a future capital call notice from the general partner. There is no new investment decision made in this situation. The investor has already made his or her decision and, if he or she was not permitted to contribute the capital he or she already committed to invest, it would pose an undue hardship on the fund and the other investors in the fund, as well as cause the investor to violate a valid contractual commitment.

Issue 4: Pool Employees. The Commission has requested comment regarding whether employees of private investment pools or their investment advisers[35] (collectively, "pool employees") should be subject to the same accredited natural person standard as other natural persons.[36]

Response: For the following reasons, we believe that pool employees should not be subject to proposed Rules 509 and 216. First, we believe that individuals who work full-time for managers of private investment pools and are "accredited investors" under the current standards have sufficient financial knowledge and sophistication to enable them to evaluate the risks of investing in Section 3(c)(1) pools that their firms manage. Such employees generally understand the investment strategies, risks and fee structures of these pools. They have ready access to information and daily exposure to the firms' investment and risk management processes.

Second, we believe that applying the accredited natural person standard to pool employees may preclude many of these employees from investing in the pools they help manage. The primary benefit of allowing pool employees to invest in investment pools is that such investment maximizes pool employees' incentive to promote the pool's performance, thus aligning their interests with the interests of other investors in the pool. Subjecting pool employees to the accredited natural person standard would eliminate such benefits and make it more difficult for investment advisers to motivate and retain talented personnel.

In addition, the accredited natural person standard (as any standard based on size of investment or net worth) is an imperfect proxy for identifying the class of persons who have the ability to understand the risks of an investment in the pool. The accredited natural person standard disadvantages young investors who may be extremely sophisticated with multiple degrees from institutions of higher education and who may be employed by the investment adviser but have yet to amass a sufficient quantity of investments to qualify as accredited natural persons. While exempting pool employees from the proposed rules' standards does not solve that problem, it would go a long way towards diminishing the inequity created by the proposed rules.

[35] We note that private investment pools rarely, if ever, have any employees and that substantially all pool employees are employed by an investment pool's investment advisers. This discussion is framed in that context.

[36] Proposing Release at 406-407.

Continuing to apply the existing accredited investor standard to pool employees would ensure that such employees have the economic ability to bear the risk of an investment in a Section 3(c)(1) pool. In contrast to the Commission's suggestion in the Proposing Release, we believe that few private investment pools allow investments by pool employees who are not accredited investors under the current standards. The regulatory constraints associated with offering and selling interests to non-accredited investors make such practices burdensome and impractical for many investment pools.

First, if a private investment pool were to issue its securities to any non-accredited purchasers, Rule 502(b) would require disclosure to such purchasers (and, as a practical matter, in most cases to accredited investors as well) of the same kind of information as would be required in Part I of a registration statement filed under the Securities Act on the appropriate form (subject to a materiality test). We believe that well-prepared offering materials for a private investment pool generally contain most of this information, but this information may not be in the same format as presented in a registration statement. Private investment pool offering materials also may omit some information that would technically be required in a registration statement but not in a Rule 506 offering because such omission is immaterial to a decision whether to invest in a private investment pool, such as audited financial statements of the general partner or the investment manager, and typically do not disclose compensation information of individuals who are members of a limited liability company (or partners of a limited partnership) acting as general partner. These differences between the offering materials for a private pool and those for a registered offering could become an invitation to a claim in the event of market losses. Given the expense of defending a claim under such circumstances, and the risk, however remote, of the private investment pool's reliance on Rule 506 being vitiated in the event of an adverse determination, most fund managers simply choose to exclude non-accredited investors from their funds.

Second, most hedge funds offer their securities continuously, accepting new investments on a quarterly or other periodic basis. As a result, a hedge fund manager who admits non-accredited investors in reliance on Section 4(2) would be unable to rely subsequently on Regulation D under the integration principles of Rule 502(a), unless the offering were terminated and not commenced again for at least six months. Any such hiatus would often, if not always, have a severely detrimental effect on the ability of a hedge fund to increase its asset base. In addition, as the Proposing Release correctly acknowledges, reliance on Section 4(2) is fraught with uncertainty and few investment advisers are likely to be willing to accept that risk in the age of Regulation D.

We believe that these regulatory impediments to offering and selling pool interests to non-accredited investors prevent most pool managers from doing so. We believe that the existing accredited investor standards provide an adequate objective measure of pool employees' economic ability to withstand the risks of investment in pools managed by their employers. We also believe, as stated above, that the accredited natural person standard, rather than providing essential additional protection to pool employees, would unnecessarily restrict their ability to invest in pools with which they have significant familiarity. Accordingly, we believe that the accredited natural person standard should not apply to employees of the investment advisers to Section 3(c)(1) pools as long as they are "accredited investors" under the existing definition of accredited investor contained in Rule 501(a) ("Accredited Employees").

We recognize that pool employees are sometimes granted contractual rights to portions of the management fees or performance fees or allocations from private investment pools. However, these are compensation arrangements tied to specific income streams to the managers that reflect shorter-term investment performance. Thus, they do not have the same long-term motivational impact as a direct investment in the investment pool. Many general partners and other managers of private investment pools believe direct investment is substantially more likely to align the pool employees' interests with the interests of other pool investors. Many managers forbid outside investing to avoid conflicts, and allow investments in their funds to compensate for this restriction.

We believe that family members of Accredited Employees also should be excepted from the heightened "accredited natural person" standard and should instead remain subject to the existing accredited investor standard. The nature of such an investor's relationship with an Accredited Employee demonstrates that the investor has the benefit of assistance from someone who is well-qualified to evaluate the merits and risks of an investment in a private investment vehicle. Accredited Employees are highly likely to understand the investment strategies and fee structures of a private investment pool as well as or better than anyone an investor might hire for such a purpose.

As with our proposal for enabling Accredited Employees to invest in Section 3(c)(1) funds, allowing their family members ("Accredited Family Members") to invest takes into account both steps of the Commission's two-step approach by balancing knowledge with ability to bear risk.

We believe that the cost of subjecting family members to the proposed "accredited natural person" standard would outweigh any investor protection benefits of the new standard. The new standard would prevent the creation of smaller funds that depend on such family members for initial funding and generally discourage entrepreneurship in the private investment pool arena. Accordingly, we propose that the Commission define "Accredited Family Members" as "any spouse, former spouse, parent, child, sibling, mother- or father-in-law, son- or daughter-in-law, or sister- or brother-in-law, including step and adoptive relationships" of an Accredited Employee, and "the estates of such persons, or foundations, charitable organizations, or trusts established by or for the benefit of such persons" who meet the current accredited investor standards.

Issue 5: Knowledgeable Employees. The Commission has also requested comment on whether certain "knowledgeable employees" as defined in Rule 3c-5 under the Company Act should be added to the list of accredited natural persons in the proposed rules.

Response: We believe that the inclusion of "knowledgeable employees," as defined in Rule 3c-5 of the Company Act, should be included in the definition of accredited natural persons under the proposed rules because of their financial sophistication and knowledge; however, as noted above, this solution is not sufficient to cover all employees who may have the financial sophistication to invest in Section 3(c)(1) pools. As indicated above, we recommend that Accredited Employees and Accredited Family Members be permitted to invest in Section 3(c)(1) pools. Many employees who, by virtue of their experience with the pool (or other pools) and/ or education, are sufficiently sophisticated to understand the risks of investing in the pool, but are restricted from doing so if the list of eligible employees is limited to "knowledgeable employees". This comports with our experience as practitioners in dealing with the knowledgeable employee standard. Employees, such as research analysts, compliance, legal, and administrative personnel, and others simply do not meet the "knowledgeable employee" standard, although frequently they have the expertise and experience to understand the risks of the investment. This inequity would be addressed, to a certain extent, if pool employees who meet the existing accredited investor standards were permitted to invest in Section 3(c)(1) pools, or if the Commission revised Rule 3c-5 of the Company Act to expand the definition of "knowledgeable employees."

Issue 6: Jointly Owned Investments. The Commission has proposed a definition of investments different from that contained in Rule 2a51-1 under the Company Act. In contrast with the proposed rules, Rule 2a51-1 permits all jointly owned investments to be included in the determination of whether a natural person is a "qualified purchaser" under Section 2(a)(51)(A) of the Company Act. The proposed rules state that a person acting as an individual, and not in conjunction with a spouse, should be permitted to count only fifty percent of: (a) investments jointly held with his or her spouse; and (b) any investments in which the person shares a communal property or similar shared ownership interest with his or her spouse. The Commission has requested comment on whether the proposed definition of investments is appropriate.

Response: We believe that the Commission should follow the established treatment of jointly owned investments under Rule 2a51-1. Proposed Rules 509 and 216 take an approach to investments held jointly by spouses that is inconsistent with current tests. In our view, there is no articulated reason to support such a change, and there are sufficiently different tests under the securities laws to avoid adopting another without a sound articulated basis. Under the current net worth test contained in Rule 501(a) under Regulation D, there is one amount – $1 million – that applies, whether the assets are owned individually or jointly with a spouse. Furthermore, if one spouse invests individually, that spouse is able to include in his or her calculation of net worth the value of any assets held jointly. In Rule 2a51-1(g)(2) under the Company Act, all investments may be included in determining whether a natural person is a qualified purchaser for purposes of Section 2(a)(51)(A), regardless of whether one is investing individually or jointly with a spouse.[37]

[37] 17 C.F.R. § 270.2a51-1(g)(2).

The Commission also does not explain how splitting the value of property held jointly with a spouse or shared as community property would reflect more accurately an individual's financial knowledge and sophistication. We see no reason why spouses should be adversely affected and possibly precluded from investing in a fund just because for estate planning, tax or other similar purposes, they elect to make joint investments in some circumstances, but not others.

Additionally, we also do not believe this is an "apples to apples" comparison, as Regulation D specifically does not require individual investors to split assets held jointly with a spouse in determining their net worth.[38] This provision applies an additional limitation on those who may be able to invest in private investment vehicles that rely on Section 3(c)(1). We urge the Commission to maintain the position it has taken before and allow a person investing individually to include all assets owned jointly with such person's spouse in determining the amount of such person's investments.

Issue 7: Venture Capital Funds. The Commission states in the Proposing Release that offers and sales of securities issued by "venture capital funds" would be excluded from the definition of "private investment vehicles," and therefore the coverage of proposed Rules 509 and 216, because the Commission recognizes the important role that venture capital funds play in the capital formation process for small businesses. Proposed Rules 509 and 216 would define a "venture capital fund" in the same manner that "business development companies" are defined in Section 202(a)(22) of the Advisers Act. The Commission seeks comment on a number of issues concerning the appropriateness of such an exclusion.

Response: We acknowledge that the Commission's proposal to exclude venture capital funds from Proposed Rules 509 and 216 is based upon a public policy determination that recognizes the important role played by venture capital funds in financing early-stage businesses. We also acknowledge that it is within the Commission's appropriate discretion to make such a public policy determination.

We note, however, in proposing to raise the investor accreditation standards under Rules 509 and 216, the Commission indicates that an investment in a private investment pool involves unique risks that are not generally associated with many other issuers of securities. These unique risks include risks associated with undisclosed conflicts of interest, complicated fee structures and the uncertainties that accompany a pool's anticipated returns, and are exacerbated by a private investment pool's use of complicated investment strategies and the lack of much publicly available information about private investment pools. We believe that investments in venture capital funds face many of the same risks as investments in other private investment pools, in addition to a lack of liquidity for portfolio companies and investors.

From the standpoint of investor protection, we do not believe there should be a difference between investing in venture capital, private equity or hedge funds. Indeed, the Commission has not articulated, in this context, the rationale for a distinction, and, considering most investment professionals recommend investors allocate some portion of their assets to alternative investments, the distinction is difficult to understand.

* * *

[38] Securities Act Release No. 6389 (March 8, 1982)("Commentators note that the proposed rules, which limited net worth to that of the individual investor presented numerous problems for investors in community property states or for investors with assets held in joint name with a spouse. Recognizing these problems, the Commission has modified the net worth test to include joint net worth").

We appreciate the Staff's attention to this matter and its consideration of the issues we have raised. We would be pleased to discuss with you and other members of the Staff any aspect of this letter. Questions may be directed to Paul N. Roth at (212) 756-2450 or to Jeffrey E. Tabak at (212) 310-8343.

Respectfully submitted,

/s/ Keith F. Higgins

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