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March 8, 2007

Ms. Nancy Morris
Secretary
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549-0609

Re: SEC Release No. 33-8766; IA-2576 (File No. S7-25-06)

Dear Ms. Morris:

The Committee on Private Investment Funds of The Association of the Bar of The City of New York (the "Committee") is composed of lawyers with diverse perspectives on investment advisory issues, including members of law firms and counsel to private advisory and financial services firms. The Committee focuses on, among other things, the issues, trends and regulations relating to a wide variety of private investment funds, including hedge funds, buyout funds, venture capital funds, mezzanine funds, distressed funds and funds of funds. (*A list of our current members is attached.*)

The Committee is pleased to submit this letter in response to a request by the Securities and Exchange Commission (the "Commission") to provide comments on the proposed rules and amendments entitled "Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles; Accredited Investors in Certain Private Investment Vehicles"; Securities Act Rel. No. 8766; Investment Advisers Act Rel. No. 2576 (December 27, 2006) (the "Release"). (Proposed new Rules 206(4)-8, 509 and 216 are each referred to herein as the "Proposed Rule")

Anti Fraud Rule

The Committee supports the Commission's objective of prohibiting advisers (whether or not registered) from making false or misleading statements to investors in pooled investment vehicles and from defrauding investors by means of fraudulent, deceptive or manipulative conduct. Moreover, we recognize the need to address the uncertainty, created by the Goldstein[1] decision and agree that, although investors in pooled investment vehicles are not "clients", advisers may not engage in fraudulent conduct in their dealings with the investors and prospective investors in such vehicles.

While we appreciate the difficulty of developing an exhaustive list of proscribed conduct, we are concerned about the broad scope of the Proposed Rule and the absence of any specific practices within the Proposed Rule's ambit. We note that Section 206-4 of the Advisers Act directs the Commission to adopt Rules to specify the type of conduct which will be deemed to be deception or manipulation. It is significant that the Commission has elected not to do so. We expect that the result of this approach will be de facto rule making through enforcement actions. That is, the Commission will identify conduct it believes to be fraudulent, by taking an enforcement action, and thereby putting the industry on notice that the particular conduct addressed by the enforcement action violates the Proposed Rule.

Our concern is compounded because, unlike Rule 10b-5 which was adopted pursuant to Section 10 of the Securities Exchange Act of 1934 ("Rule 10b-5"), the Proposed Rule would (i) apply on a continuous basis to the ongoing relationship between the adviser and the investors in a fund (unlike Rule 10b-5, which is limited to fraudulent activity in connection with a purchase or sale of a security), (ii) not require scienter (which is required under Rule 10b-5), and (iii) not require privity between the adviser and the investor.

We anticipate that the Commission's approach will have several unintended negative consequences, including the following:

1. An adviser may be held liable for statements made by the adviser which reach an investor when the relationship between the adviser and the investor is so attenuated that the adviser is not aware that it is communicating with the investor (e.g., a sub-adviser to a fund may not know that information it provides will be furnished to investors in a fund).

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1 *Goldstein v. Securities and Exchange Commission*, 451 F.3d 873 (D.C. Cir. 2006).

2. An adviser may be held liable for communications between the adviser and an investor which (a) do not result in the sale of securities or any services of the adviser, (b) which the adviser had no reason to expect would be relied on by the investor and (c) were made without scienter.

3. If a misleading statement is made in connection with the sale of securities by a fund, the issuer can only be held liable if the issuer acted with scienter. The investment manager can be held liable for the same misleading statement simply because it is misleading.

4. Because of uncertainty surrounding the types of conduct by an adviser that may lead to liability, advisers will choose to make as little information as possible available to investors in private funds, thereby decreasing investors' ability to understand and consider potential investments and to engage in meaningful dialogue with advisers. In addition, the increased costs of compliance, coupled with a concern that there will be greater liability for providing information, will result in less transparency.

In the Release, the Commission acknowledged that the Proposed Rule does not create a fiduciary duty to investors[2]. We urge the Commission not to stretch the "fraudulent, deceptive or manipulative" conduct standard into the equivalent of a federal fiduciary duty.

Accordingly, we ask the Commission to reconsider Proposed Rule 206(4)-8 by:

(i) imposing a scienter requirement (a concept which is well developed and understood under Federal securities law);

(ii) requiring that in order for a violation of the Proposed Rule to be actionable, there be privity or demonstrated reliance by the investor, or evidence that the adviser had, or should have had, a reasonable expectation that the information would be provided to third party investors; and

(iii) whenever possible, the Commission should be proactive in announcing the type of conduct or practices that would be viewed as violating the Proposed Rule before taking enforcement action; any such announcement will assist advisers in understanding the type of conduct which is proscribed and limiting their liability under the Proposed Rule.

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2 Release at page 14.

Accredited Natural Person Definition

Rule 501(a) of Regulation D currently defines the term "accredited investor" to include a natural person whose individual net worth or joint net worth with the person's spouse, exceeds $1,000,000 at the time of purchase, or whose individual income exceeds $200,000 (or joint income with the person's spouse exceeds $300,000) in each of the two most recent years and who has a reasonable expectation of reaching the same income level in the year of investment. The $1,000,000 net worth and $200,000 income standards were adopted by the Commission in 1982. The Release points out that in the ensuing 25 years "inflation, along with the sustained growth in wealth and income of the 1990s has boosted a substantial number of investors past the 'accredited investor' standard".[3]

We acknowledge the need to increase the minimum net worth standard to be satisfied by an individual to qualify as an accredited investor. However, we do not find the Commission's approach to be suitably tailored to the objectives the amendment seeks to achieve, for the following reasons.

In particular:

1. As acknowledged by the Commission, the increase to $2.5 million for natural persons (not assets jointly held with a person's spouse) significantly outpaces the change that would result from merely increasing the $1,000,000 minimum net worth requirement by the annual rate of inflation over the 25 years following the adoption of Regulation D.

2. Because the "accredited natural person" standard is indexed to inflation, whereas the "qualified purchaser" standard applicable to investors in 3(c)7 funds is not, it is possible that in the future the threshold for "accredited natural person" status will be higher than the threshold for qualification as a "qualified purchaser." Given that the financial requirements for investment in 3(c)1 funds are intended to be lower than for investment in 3(c)7 funds, this result would make no sense.

3. We recognize that investments in residential real estate do not necessarily reflect investment acumen. However, excluding residential real estate further compounds the excessive increase reflected in the proposed new minimum.

4. The Proposed Rule presumes, without providing empirical support, that investors in privately offered funds do not have access to the kind of information provided through our system of securities regulation. While we do not necessarily agree with this premise, the same concerns should be equally applicable to private investments in operating companies. No rationale has been provided for singling out 3(c)1 funds and

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[3] Release at p. 17.

not making the same requirement applicable to private investments in operating companies. In many cases, an investment in an operating company is significantly more risky than an investment in a private fund that holds a diversified portfolio of marketable securities. Inflation and increasing wealth has had the same impact on the ability of investors to invest in operating companies as it has had on investors desiring to invest in private funds. Investments in operating companies should raise the same concerns with respect to investor protection as those expressed with respect to investments in private funds, yet no explanation has been provided for singling out the private funds industry.

5. The value of the investments held by an individual is a poor surrogate for investment sophistication. An investor may have a significant investment portfolio, but no experience investing in privately offered securities. For this reason, we do not find the rationale for departing from a net worth approach and focusing upon the value of the investments held by a prospective investor to be persuasive.

6. Requiring investors in 3(c)1 funds to qualify as both accredited investors and accredited natural persons introduces unnecessary complexity into a process which is already burdensome. It is difficult to imagine a circumstance in which an investor would qualify as an accredited natural person, but not satisfy the current $1 million net worth test.

Additionally, our Committee is concerned about some of the intended and unintended consequences of the Proposed Rule:

1. The change will increase the barriers to enter the private funds industry, reducing competition and limiting the investment options available to investors. New start up managers, who are dependent upon friends and family for initial support, will have more difficulty raising capital since fewer friends and family will qualify to invest. Institutional investors often wait to invest until the manager has been in operation for some period of time and has created a track record. If a start up manager is unable to accept capital from friends and family, it may not be able to attract sufficient capital to launch and commence operations.

2. Currently, few private fund managers permit unaccredited investors to invest in their funds. After the Proposed Rule is adopted, managers will increasingly be compelled to rely upon the ability afforded by the Proposed Rule to allow 35 unaccredited investors to invest. There are no income or net worth requirements applicable to such unaccredited investors.

3. The change will have a disparate impact on smaller managers and start-ups. It will have little or no impact on large established managers who raise capital primarily from institutional investors.

4. Managers whose business model is to focus on high net worth investors will be adversely affected. Current investors who no longer qualify to invest in

a fund will not be able to add to their investment and the pool of eligible prospective investors will be dramatically reduced. Existing 3(c)1 funds will shrink in size (thereby causing operating expenses to increase as a percentage of net assets), since investors who are no longer qualified will not be able to add to their investment and it will be difficult to replace those who withdraw. No statistics were offered in the Release on the anticipated number of investors who will qualify under the new standard. However, since investors who have more than $5.0 million in investments are able to invest in 3(c)7 funds, the number of investors who will be eligible to invest in 3(c)1 funds, but not eligible to invest in 3(c)7 funds (those who have more than $2.5 million investments, but less than $5 million), is likely to be extremely small.

5. Small foundations, pension plans and endowments (those with total assets in excess of $5 million, but less than $25 million in investments), will have limited opportunities to invest in hedge funds and other private funds. They will not be eligible to invest in 3(c)7 funds, and since there is likely to be a significant reduction in the number of 3(c)1 funds, few funds will be available to such investors.

Alternative Proposal

In response to these concerns, the Committee proposes that (i) minimum net worth, rather than minimum investments, should be retained as the standard to be satisfied for achieving accredited investor status; (ii) the determination of net worth should continue to include a personal residence, and (iii) the minimum required net worth (defined as joint net worth with a person's spouse) should be increased from $1 million to $2 million, a threshold which would appropriately reflect the impact of inflation. We also recommend that this change be made applicable to all securities offerings being made pursuant to Regulation D.[4]

Exclusion for Venture Capital Pools

The requirement in the Proposed Rules that investors qualify as "accredited natural persons" is not intended to apply to the offer and sale of securities issued by venture capital funds. While we are not convinced of the rationale provided for carving out venture capital funds, if the exception will be retained, we believe the proposed definition is unduly narrow. As defined in the Proposed Rules, a venture capital fund would have the same meaning as the definition of business development company in section 202(a)(22) of the Advisers Act. We find that this definition is too narrow to accomplish the intention of the Proposed Rules. The proposed definition

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[4] If the Commission were to adopt this approach (i.e., simply increase the net worth requirement, eliminate the requirement for a minimum amount of investments and apply the modified accredited investor standard to all Regulation D offerings), then we would also recommend that the Commission correspondingly increase the income requirements for qualification as an accredited investor.

would only refer to domestic vehicles investing primarily in onshore investments. There is no reason why the exclusion should be limited to this type of venture capital fund. Rather, the definition of venture capital fund should also include offshore vehicles and vehicles that invest in offshore investments. We propose that the Commission use the definition provided in section 202(a)(22), but adapt it so that it applies to non-domestic vehicles as well as non-domestic investments that would otherwise meet the definition.

Knowledgeable Employees

The Committee strongly supports any changes to the Proposed Rule which would facilitate the ability of knowledgeable employees to invest in the funds advised by the investment managers by whom they are employed.

As currently drafted, the Proposed Rule creates an anomalous result. By its terms, the accredited natural person requirement applies only to 3(c)1 funds. Hence, knowledgeable employees would continue to be able to invest in 3(c)7 funds without regard to whether they are accredited natural persons, but must satisfy the higher accredited natural person standard to invest in 3(c)1 funds. The proposal will have little or no impact on large established managers, who are likely to have 3(c)7 funds in which their employees can invest. Those smaller managers, or start ups, who manage 3(c)1 funds, will not be able to offer to their employees the opportunity to invest in their advised funds unless they utilize one or more of the 35 places available for non accredited investors.

In determining whether to invest in a private fund, investors seek to ensure that the interests of the manager are aligned with those of the investor. Clearly one way of assuring that this is the case is for managers (including its principals and employees) to have their own money at risk in the fund. Moreover, fund advisers, as employers, seek to incentivize employees by giving them a stake in the success of the fund. While many advisers seek to accomplish this through compensatory programs, allowing employees to express their confidence in their firm by putting their own money at risk is equally important. Permitting knowledgeable employees to invest in 3(c)1 funds without regard to their eligibility as accredited natural persons would be a first step in ameliorating this problem.

While outside the scope of the Proposed Rule, there are two other important actions that should be taken by the Commission to facilitate investment by qualified employees.

First, the definition of "knowledgeable employee", as set forth in Rule 3c-5 adopted pursuant to the Investment Company Act, should be broadened. Currently, the definition is generally limited to investment professionals. There are other senior employees, particularly those in the accounting and back office part of the business and those involved in marketing, who have the requisite knowledge, sophistication and experience to invest in a fund. The definition of knowledgeable employee should be

expanded to allow any professional employee to invest in an advised fund, provided he or she has the required minimum experience (Rule 3c-5 under the Investment Company Act currently mandates at least one year of experience), access to portfolio information and the ability to ask questions and obtain answers from senior management concerning the fund's operations and performance.

Second, we urge the Commission to adopt a consistent definition for purposes of the Investment Company Act, Section 205-3 of the Investment Advisers Act (the performance fee rule) and Regulation D. Regulation D, in particular uses the term "executive officer" which is tailored to operating companies. The Proposed Rule should provide that any employee who is a knowledgeable employee under Rule 3c-5 of the Investment Company Act is also an accredited investor for purposes of Regulation D and a qualified client for purposes of Rule 205-3 of the Advisers Act.

Grandfathering

The Release does not attempt to quantify the number of investors who are currently investors in 3(c)1 funds and would suddenly find themselves ineligible to add to their investment by virtue of the fact that they do not qualify as accredited natural persons.

When Congress amended the Investment Company Act in 1996 to enact 3(c)7, investors in funds that converted from 3(c)1 to 3(c)7 were allowed to remain in the fund and add to their investment. Similarly, when the Commission sought to require hedge fund managers to register as investment advisers, it permitted investors who did not satisfy the $1.5 million minimum net worth requirement to be treated as a qualified client under Rule 205-3 of the Investment Advisers Act, to remain in the fund and continue to pay performance fees. Hence, we are surprised by the Commission's proposal to grandfather investors who do not qualify under the new standard by allowing them to remain in a fund, but not to permit them to add to their investment. Those investors who have already made the decision to invest in the fund are likely receiving periodic reports which have allowed them to become familiar with the fund's operations and are likely to be more knowledgeable investors with respect to the fund than a prospective new investor. We see no reason to make a distinction which allows an investor to make the investment decision required to maintain an existing investment, but not to add to that investment.

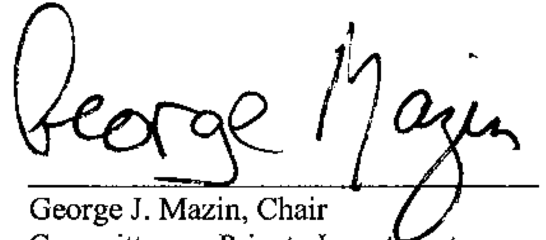
Accordingly, we urge the Commission to modify the Proposed Rule to allow grandfathered investors to continue to invest in funds in which they invested prior to the Proposed Rule change without restriction, and without requiring fund advisors to treat the investment as an investment by a non-accredited investor, thereby using one of the 35 non-accredited slots available.

Transition Period

The Proposal does not address the need for a transition period. If adopted, existing managers will be required to incur a significant expense to revise and update all existing fund documentation for 3(c)1 funds. Moreover, managers will be required to educate fund administrators to familiarize them with the new standards and the procedures that will be employed to screen existing and new investors for eligibility. As a result, we urge the Commission to adopt a minimum 6 month transition period before the changes become effective.

We hope that these comments contribute to the important work of the Commission in the area of private funds. Please note that the comments and observations set forth in this letter by the Committee do not necessarily represent the views of the firms or companies with whom the Committee members are associated or the clients that they represent.

Very truly yours,



George J. Mazin, Chair
Committee on Private Investment Funds