File number S7-25-06 (increasing the investor accreditation standards) is a measure with flaws, and there are better alternative approaches to the problem. The SEC's end goal is better monitoring and policing of the rapidly growing hedge fund industry. But in trying to protect the small investor, the proposed rule denies access to that same class, and they are the ones that need the diversification benefits the most.

Hedge funds can play an important role in providing portfolio diversification. Ultra high-net worth individuals and large institutions have long benefited from their hedge fund allocations. Countless academic papers have even sung the praises of hedge funds including *Liang (1999), Schneeweis (2000), Fung, Xu and Yau (2002),* and *Asness (2004*). In fact, some of our country's most prestigious academic institutions, such as Harvard and Yale, are also some of the country's largest hedge fund investors. If one can argue the diversification benefits, then this tool should be available to more than just the upper echelon of society.

The intent appears to be to protect investors from fraud. Fraud does occur in hedge funds. Yet, it also occurs due to unscrupulous financial planners, insurance salesman, brokers, etc. Why limit this protection to just hedge funds? Currently, real estate speculation is not prohibited, which by its nature is typically leveraged. Nor was the speculation in tech companies during the late 1990's restricted. The proposed rule is trying to limit investments of hedge funds to only the sophisticated investor so as to protect the unsophisticated investor. That is a worthy cause, but the question remains how one defines sophistication. The SEC has previously decided to define it based on one's net worth and income. It is now proposing to increase those standards. Is a wealthy individual who has received his windfall through passive means any more sophisticated than a finance professor who toils in academia? How can the SEC arbitrarily define sophistication as net worth? Furthermore, what specific level of net worth is deemed to be sophisticated?

By increasing the accreditation standards, an individual's freedom of choice is severely curtailed. This is the very type of investor that can use the diversification benefits the most. Top tier institutions have a myriad of available investment options due to their size and network. The individual the SEC defines as the unsophisticated investor does not have those same options. Often, these same investors tend to suffer from an over allocation to equity investments. Further limiting choice will only serve to increase this concentration.

In reality, the small, retail investor will not invest in hedge funds. Many hedge fund strategies are capacity constrained. Therefore, most hedge fund managers tend to have very large account minimums. Yet, for those individuals, and smaller institutions, that have the scale and financial wherewithal, diversifying a portion of their portfolio into hedged strategies would seem a prudent act. At the very least, the SEC should consider allowing “unsophisticated” investors to invest in hedge funds through knowledgeable and qualified representatives. Another option may be to limit investment to only qualified fund of funds, who themselves are diversified. This would help offset single manager risk.

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