FABER BANTZ PC

March 9, 2007

To the Commissioners of the Securities and Exchange Commission:

Faber Bantz PC ("Faber Bantz") respectfully disagrees with the Securities and Exchange Commission's (the "Commission") proposed rule revising the definition of "accredited investor." Our law firm provides legal services to hedge funds and private equity funds and believes the proposed rule would adversely affect such small to mid-size funds. In addition, we believe the current definition of "accredited investor" adequately protects investors from fraudulent activities by fund managers. Faber Bantz urges the Commission to retain the current definition of "accredited investor" for the reasons that follow.

The Commission has failed to produce any evidence supporting its redefinition of "accredited investor." Applicable law requires the Commission to articulate a rational connection between the facts found and the rule it proposes; the Commission must examine the relevant data and articulate a satisfactory explanation for its action.[1] The current definition of "accredited investor" was adopted in 1982 and includes a natural person with a net worth of $1 million. The rule was proposed to keep supposedly unsophisticated investors from investing in private investment pools, such as hedge funds, because the funds were considered riskier than mutual funds. In proposing its new rule, the Commission offered no rationale supporting its implication that an investor with $2.5 million in investable assets is better suited to determine the quality of an investment than an investor with a net worth of $1 million. The Commission failed to present any evidence indicating that a person's wealth is an appropriate measure of a person's investment experience, financial knowledge, and sophistication. With the research tools and financial information now available on the Internet, even people with few investments have access to information that only the very wealthy had access to in 1982.

In addition, the Commission has failed to present evidence suggesting that a significant number of retail investors are investing in private investment pools. A 2003 staff report by the Commission regarding the implication of the growth of hedge funds stated "to date . . . the staff has not uncovered any evidence of significant numbers of retail investors investing directly in hedge funds."[2] The study also found that hedge fund managers "do not seek retail investors because such investors may not be suitable for the inherent risks that accompany some hedge funds and that the effort required to ensure such suitability often outweighs the benefit of any

[1] *See, e.g.,* Motor Vehicle Mfr.'s Ass'n. v. State Farm, 463 U.S. 29 (1983) and Bowman Transp., Inc. v. Arkansas Best Freight, 419 U.S. 281 (1974).

[2] Implications of the Growth of Hedge Funds, Staff Report to the United States Securities and Exchange Commission, September 2003, p. 80 [hereinafter *Implications of the Growth of Hedge Funds*].

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investments that they might make."[3] The Commission's failure to articulate a reasonable rationale for its proposed rule subjects it to a potential legal challenge. In *Goldstein v. Securities and Exchange Commission*, the United States Court of Appeals for the District of Columbia Circuit invalidated a Commission rule requiring hedge fund managers to register with the Commission finding that, "without any evidence that the role of fund advisers with respect to investors had undergone a transformation, there is a disconnect between the factors the Commission cited and the rule it promulgated."[4] The Commission's proposed rule may be similarly invalidated because the Commission has failed to present evidence to support the revision to the current definition of "accredited investor."

The proposed rule severely limits the investment choices of the average American by allowing only the richest 1.37% of American households to invest in private investment pools. The Commission's proposed rule further increases the disparity between the wealthy and the middle class in America. All investors should be allowed to diversify their portfolios with private investment pools as they can offer higher returns with lower levels of risk.

In addition, the impact of the proposed rule will be borne by small to mid-size private investment funds. The proposed rule substantially reduces the number of investors who may invest in these funds. While large funds will be able to retain many of their investors, the proposed rule will be disastrous for smaller funds. Therefore, Faber Bantz urges the Commission to consider the negative impact the proposed rule will have on small to mid-size private investment pools.

There are less burdensome means for the Commission to achieve its goal of protecting the public from fraudulent acts by managers of private investment pools. In its proposed rule, the Commission has presented little evidence indicating that managers of private investment pools have participated in fraudulent activity, and in its 2003 report, the Commission stated that there is "no evidence indicating that hedge funds or their advisers engage disproportionately in fraudulent activity."[5] While the Commission cited several concerns in its 2003 report, such as a fund manager's misappropriation of assets; misrepresentation of portfolio performance; falsification of experience, credentials, and past returns; misleading disclosures regarding trading strategies; and improper valuation of assets,[6] these issues are better addressed by imposing restrictions on private investment pool managers rather than by revising the definition of "accredited investor." Currently, managers of private investment pools are subject to the antifraud provisions of the federal securities laws.[7] In addition, the Commission's proposed rule prohibiting investment advisers from making false or misleading statements or otherwise defrauding investors or prospective investors further articulates the responsibilities of fund managers. Finally, there has been a push for private investment pools to adopt a uniform code of ethics, and encouragement by the Commission may prompt the industry to pass a code of ethics.

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[3] *Id.* at 80-81.
[4] 451 F.3d 873, 882 (D.C. Cir. 2006).
[5] *Implications of the Growth of Hedge Funds,* supra note 2, at 73.
[6] *Id.*
[7] 15 U.S.C. 80b-6 (2006).

If the Commission decides to adopt the proposed rule revising the definition of "accredited investor," Faber Bantz urges the Commission to modify the rule to exclude its application to venture capital funds. We ask the Commission to define venture capital funds as funds described in the Investment Company Act of 1940 Section 3(c)(1) that permit their owners to redeem their ownership interests two years *after* the purchase of such interests. The Commission has stated that it "has not encountered significant enforcement problems with advisers with respect to their management of [funds with a holding period of two years or more]."[8] In addition, we believe the Commission should adopt a provision allowing an investment pool to redeem securities in the case of an "extraordinary circumstance," such as an investor's death, serious illness, total disability or other emergency; an investor's bankruptcy or liquidation; in the event that the investment becomes impractical or illegal; in the event that key personnel of the investment pool become incapacitated, or cease to be involved in the management of the pool for an extended period of time; in the event of a merger or reorganization of the investment pool; a potential adverse tax or regulatory outcome; or in order to keep the investment pool's assets from being considered benefit plan assets under ERISA.

In conclusion, the Commission's failure to present any evidence supporting its implication that wealthy people are more sophisticated investors makes it difficult for the public to adequately comment on the proposed rule. The lack of evidence supporting the proposed rule and the Commission's failure to articulate a reasonable basis for the proposed rule subjects it to a potential legal challenge. There are less burdensome means to achieve the Commission's goal to prevent fraudulent activity by investment pool managers, and Faber Bantz encourages the Commission to consider enforcing the anti-fraud rules of the federal securities laws as well as encouraging the industry to adopt a uniform code of ethics as opposed to revising the definition of "accredited investor." We appreciate your attention to this matter, and thank you for considering our comments.

[8] 69 FR 72054, 72074 (Dec. 10, 2004).

Sincerely,

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