SBαS

Santa Barbara Alpha Strategies

March 7, 2007

Ms. Nancy M. Morris
Secretary
Securities and Exchange Commission
100 F. Street, N.E.
Washington, D.C. 20549

Re: File No. S7-25-06; Release No. 33-8766

Dear Ms. Morris:

I am submitting this letter in response to the Securities and Exchange Commission's ("SEC" or "Commission") request for comments on the proposed rules on eligibility to invest in private investment pools. I am General Counsel to Santa Barbara Alpha Strategies ("SBAS"), a registered investment advisor. SBAS specializes in designing and managing multi-strategy, multi-manager, alpha investment portfolios. Our clients include not only foundations, endowments, and pension funds, but also high net-worth individual investors. Because of our direct involvement in the hedge fund industry, SBAS would be materially and adversely impacted by the adoption of unnecessary or ill-advised rules pertaining to hedge funds.

As I will discuss in more detail below, I do not support the adoption of proposed Rules 509 and 216. *First*, the proposed rules on the eligibility to invest in private investment pools are flatly inconsistent with the statutory scheme erected by the Investment Company Act of 1940 ("Company Act"). *Second*, the Commission has failed to demonstrate that its proposed rules will further the statutory goals of the Securities Act of 1933 ("Securities Act"). *Third*, the rules are unjustified by the Commission's policy arguments.

A. Proposed Rules 509 and 216 Impermissibly Alter the Statutory Scheme Designed By Congress

The Company Act exempts two types of issuers from the definition of an "investment company" within the meaning of the chapter. These exemptions are defined in distinct ways. Under 15 U.S.C. § 80a-3(c)(1), an issuer whose securities are owned by "not more than one hundred persons," does not make a public offering of its securities, and meets certain other ownership requirements, will not be considered an investment company for the purposes of the Company Act. Under 15 U.S.C. § 80a-3(c)(7), an issuer whose securities are owned exclusively by "qualified purchasers" *regardless* of the number of investors, does not make a public offering of its securities, and meets certain other ownership requirements, will also lie outside the definition of an investment company. A qualified purchaser, as defined by 15 U.S.C. § 80a-2(a)(51)(A), includes, *inter alia*, "any natural person . . . who owns not less than $5,000,000 in investments, as defined by the Commission." As the statutory text makes clear, these two exempt classes of issuers are defined in radically different ways: those issuers exempt under 3(c)(1) ("3(c)(1) Pools") are so by virtue of the *number* of investors, while those exempt under 3(c)(7) ("3(c)(7) Pools") are so due to the *kind* of purchasers of the securities.

The Commission has promulgated a rule that will impermissibly collapse these two categories by imposing a *qualitative* requirement on 3(c)(1) Pool investors, even though the Pools are defined by Congress through a *numerical* standard. The effect of new Rules 509 and 216 will be to impose a "two-step approach" on the question of to whom a Pool, in order to be exempt under 3(c)(1), may sell its securities. This two-step approach will be almost identical to the approach used in 3(c)(7). This move cannot be sustained as it is directly contrary to congressional intent in designing the two distinct exemptions to the requirements of the Company Act.[1]

As an initial matter, the Commission has not promulgated this rule pursuant to its authority under the Company Act: the Commission invokes its authority under *only* the Securities Act, referring to 15 U.S.C. §§ 77b(15), 77c(b), and 77s(a). The Commission has chosen to define a new category of accredited investor.[2] Section 4(6) of the Securities Act, 15 U.S.C. § 77d(6), exempts issuers from the registration requirements attaching to public offerings

[1] *See Chevron, U.S.A., Inc. v. NRDC, Inc.*, 467 U.S. 837, 843 n. 9 (1984) (stating that the judiciary must "reject administrative constructions which are contrary to clear congressional intent").

[2] "Accredited investor" is defined by statute, *inter alia*, as "any person who, on the basis of such factors as financial sophistication, net worth, knowledge, and experience in financial matters, or amount of assets under management qualifies as an accredited investor under rules and regulations which the Commission shall prescribe." 15 U.S.C. § 77b(a)(15)(ii).

if the issuer's offer does not exceed $5 million of securities and the issuer does not engage in advertising or public solicitation. Currently, to ensure that they are compliant with Section 4(6), most investment pools rely on the safe harbor provided by Regulation D, 17 C.F.R. § 230.501-508, when making offers and sales of their securities. Under Rule 506, an issuer may sell securities to "accredited investors," defined, *inter alia*, as a natural person whose individual net worth (or joint net worth with the individual's spouse) exceeds $1 million at the time of purchase, 17 C.F.R. § 230.501(a)(5), or whose individual income in each of the two most recent years exceeded $200,000 (or whose joint income with a spouse exceeds $300,000), and who reasonably expects to reach the same income level in the investment year. *Id.* at 230.501(a)(6).

The Commission has proposed to narrowly amend Regulation D to add an additional requirement to the income test of Rule 501's definition of accredited investor.[3] Under the proposed rule, an "accredited natural person"—a category that includes *only* to those individuals who wish to invest in a 3(c)(1) Pool—must meet not only the net worth or income test but also a new requirement of $2.5 million in investments. The Commission concedes that this proposed rule makes the requirements affecting 3(c)(1) Pools almost identical to the types of requirements governing 3(c)(7) Pools.

Although the Commission is permitted to define an "accredited investor," for purposes of the Securities Act, it is not permitted to do so in a way that is directly contrary to the statutory scheme erected by Congress. The Commission has an obligation to consider the overarching statutory scheme erected by the Company Act when interpreting the Securities Act.[4] The Company Act puts in place a regulatory structure that exempts two types of hedge funds that meet two *entirely different* types of requirements. While the exemption for 3(c)(1) Pools turns on the small number of investors, the exemption for 3(c)(7) turns on whether the investors are accredited. Congress made the choice to impose the "qualified purchaser" requirement on 3(c)(7) Pools, but did *not* do the same to 3(c)(1) Pools. Had Congress wished to limit the participants in 3(c)(1) Pools to those who met certain investment levels—as it clearly did in the case of 3(c)(7) Pools—it could have done so. But it did not.

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[3] Rule 216 applies to private offerings under Section 4(6). As the Commission does not discuss the rules separately in its Release, we will do the same.

[4] *See FDA v. Brown & Williamson Tobacco Corp.*, 529 U.S. 120, 133 (2000) ("[T]he meaning of one statute may be affected by other acts . . . .").

The conclusion that Congress did not intend for 3(c)(1) Pool clients to be subject to a investment level threshold test is bolstered by the legislative history of the 3(c)(7) exemption. In the National Securities Markets Improvement Act of 1996, Congress added the 3(c)(7) exemption. The accompanying reports make clear that Congress wished to allow those investment pools "that sell their securities only to . . . sophisticated investors to sell to an unlimited number of these investors."[5] At the same time, Congress amended Section 3(c)(1) to "simplif[y] the way the 100 investor limit . . . is calculated."[6] Had Congress wished to impose investment level standards on 3(c)(1) Pools, as it had simultaneously done in 3(c)(7), it certainly could have done so.[7] Instead, Congress chose to maintain the 100-person limitation while adding a new exemption that explicitly incorporated an investment-level standard for Pool participants. Because of the explicit distinction drawn by Congress between 3(c)(1) Pools and 3(c)(7) Pools, the Commission may not promulgate regulations that blur that difference.

B. The Proposed Rules Do Not Promote Efficiency, Competition, or Capital Formation

As the Commission briefly discusses in the release accompanying the proposed rules, it is obligated to consider "whether the action will promote efficiency, competition, and capital formation." 15 U.S.C. § 77b(b). The proposed rules accomplish none of these goals.

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[5] H.R. Rep. No. 104-622, at 18 (1996), *as reprinted in* 1996 U.S.C.C.A.N. 3877, 3880.

[6] H.R. Rep. No. 104-622, at 50, *as reprinted in* 1996 U.S.C.C.A.N. 3877, 3913.

[7] *Cf. INS v. Cardoza-Fonseca*, 480 U.S. 421, 431 (1987) ("The different emphasis of the two standards which is so clear on the face of the statute is significantly highlighted by the fact that the same Congress simultaneously drafted § 208(a) and amended § 243(h). In so doing, Congress chose to maintain the old standard in § 243(h), but to incorporate a different standard in § 208(a). Where Congress includes particular language in one section of a statute but omits it in another section of the same Act, it is generally presumed that Congress acts intentionally and purposely in the disparate inclusion or exclusion." (internal quotation omitted)).

Most obviously, the proposed rules will eliminate investment options for those individuals who previously were eligible to invest in 3(c)(1) Pools and are now unable to do so.[8] The rules differentiate between those who have the net worth and income to sustain the risk that comes from investing, but simply may not have chosen to invest on a large scale previously, and those who are identically situated, but have chosen to invest heavily prior to the imposition of the proposed rule. Those who are prevented from investing may possess the sophistication and knowledge to invest in hedge funds but are arbitrarily restricted from doing so because their past investment patterns do not match the new requirements.

In addition, the proposed rule will stifle competition and innovation in the hedge fund industry as new managers and smaller start-up hedge funds are unable to enter the market or survive. By erecting such a high bar for potential investors, mangers who wish to start their own hedge funds and raise seed capital to do so will have an extremely difficult time in attracting investors. Because hedge fund managers are forbidden to advertise their product, in many cases, initial investors in a start-up hedge fund are from a smaller available set of investors and are often not the larger institutional investors that typically invest in 3(c)(7) Pools. By eliminating such a large group of potential investors, the Commission has established a massive barrier to entry in the hedge fund industry. The hedge fund industry will stagnate as new entries are eliminated.

These rules will not have any net positive effects on efficiency, competition, and capital formation. The Commission suggests that by shrinking the available pool of investors available to currently existing 3(c)(1) Pools, that competition among them will be enhanced. But as discussed above, such "competition" comes at the price of new entrants to the market, which negatively impacts competition within the hedge fund market and between other investment options. And as the Commission must acknowledge, reducing the available set of investors will disproportionately impact new and smaller hedge funds. This will negatively impact capital formation. In so doing, the Commission has thus violated its statutory mandate to *promote* these values.

[8] In addition, as discussed below, the rules will also force some current investors to cease to invest in their funds if they do not qualify as an accredited natural person.

C. The Commission Has Failed To Justify Its Proposed Rules

The Commission supports its proposed rules by explaining that requiring a certain level of investments "provid[es] an objective and clear standard to use in ascertaining whether a purchaser of a private investment vehicle's securities is likely to have sufficient knowledge and experience in financial and business matters to enable that purchaser to evaluate the merits and risks of a prospective investment, or to hire some one who can." Apart from invoking the amorphous standard of "investor protection," the Commission justifies its proposed rule by demonstrating that since 1982 (when Regulation D was promulgated, imposing the income and net worth standards), that inflation, as well as a sustained rise in wealth and home prices, has increased the percentage of U.S. households that qualify as "accredited investors." Thus, the Commission points out that in 1982 approximately 1.87% of U.S. households qualified for accredited investor status, but by that 2003, that percentage was 8.47%. The proposed $2.5 million investment level requirement would reduce the percentage of households eligible for "accredited natural person status" to 1.3%.

This analysis fails to support the proposed rules. The Commission has indicated that due to inflation, the 1982 levels for income and net worth today capture a much larger class of individuals than the rules did in 1982. But rather than adjust the income and net worth levels for inflation and other variables, the Commission has imposed an *additional* standard that simply lowers the percentage of eligible households. The Commission has not made any effort to indicate that the percentage of households captured by the addition of the investment-level requirement is congruent with the class of households captured by the 1982 income and net worth standards. Moreover, if a *different* class of persons is meant to be captured by the new rule, the Commission has failed to articulate a justification for a departure from the pre-existing structure of Regulation D governing 3(c)(1) Pools.[9] More generally, the Commission has not explained whether the increase in eligible households since 1982 has actually resulted in a broader class of persons investing in hedge funds, and if so, whether any problems have been demonstrated as flowing from the increased availability of hedge funds as an investment option.

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[9] And why, as discussed above, such a clear departure from the text of the Company Act is justified or permissible.

In addition, the Commission's decision to exclude private venture capital funds from the scope of the new rules is unsupportable. There is little difference in the risk faced by individuals investing in venture capital funds from that faced by investors in hedge funds. While the Commission seeks to justify that omission by pointing to the crucial role venture capital plays in funding start-up businesses, that has no bearing on the need to protect *investors*, which is the stated purpose of the new rules. If the entire purpose of the rule is to protect unsophisticated investors, then the fact that venture capital funds are important to the development of new business is immaterial.

Finally, the Commission is incorrect not to include a grandfather clause for those individuals already invested in 3(c)(1) Pools. The result of this failure is that investors who may wish to invest *more* in a Pool, or who are subject to an obligation to continue to invest by the rules of their particular fund, are unable to do so. Again, in light of the Commission's stated commitment to the protection of unsophisticated investors, the decision to preclude investors from continuing to invest in funds *in which they are already invested* is unsupported. Because these investors are already, presumably, familiar with the structure of the funds in which they are invested, a rule barring them from further investments in the same fund does not increase investor protection.

Conclusion

In sum, I strongly urge the Commission not to adopt Rules 509 and 216. As discussed above, these rules undermine the statutory scheme erected by Congress in the Company Act to govern hedge funds. In addition, these rules do not meet the Commission's own mandate to consider the impact of its rules on efficiency, competition, and capital formation. And finally, the Commission lacks adequate justification for the imposition of these rules.

Respectfully submitted,

Kelly D. Kaeser
General Counsel
Santa Barbara Alpha Strategies

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30 El Paseo Building | Santa Barbara, CA 93101 | 805-963-2661 phone | 805-568-5321 fax | investorservices@sbalpha.com | sbalpha.com