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Response Proposed SEC Rules and Amendments – File S7-25-06

A. Proposed Rule 206(4)-8 Prohibition of False Statements and Fraud

I support the provision, and heavy focus on the adviser side of this issue rather than establishing higher net worth or portfolio requirements.

B. Amendments to the Private Offering Rules Under the Securities Act

The proposed rules text requests commentary and expresses the Commission’s interest in setting “an objective and clear standard for ascertaining whether a purchaser of a private investment vehicle’s securities is likely to have sufficient knowledge and financial sophistication to enable the purchaser to evaluate the merits of a prospective investment in a private investment vehicle and to bear the economic risk of such an investment”.

Commentary

The proposed rule is an attempt to address two separate issues with the addition of a single qualification. I disagree with this approach, and suggest that it requires two components to become more equitable to the current investors and fund managers while addressing the two areas of concern. I provide the following commentary.

1. Knowledge and Financial Sophistication Concern

“... in the case of natural persons who seek to invest in 3(c)(1) pools outside of the structure of pension plans and pooled investment vehicles ...”

(meaning 3(c)(1) investments that are not managed or recommended by fiduciaries or registered investment professionals)

“.... While existing net worth and income tests provide some protection, we believe that additional protections may be appropriate ...”

The concern clearly is focused on natural persons that are investing in 3(c)(1) pools without using appropriate fiduciaries or registered investment professionals.

Some people are qualified to make the judgment on their own regardless of financial position. There are those that are not qualified to make such a decision, despite their financial position and should enlist a qualified person and rely upon the professional’s insight, knowledge, and experience to determine whether the person is eligible and the

investment is suitable. This means an investment advisor or a qualified registered representative with attendant fiduciary responsibilities.

The following suggestions may be simplistic, but easy to implement:

For a 3(c)(1) pool that is not registered with the SEC:

For non-sophisticated investors:

Require an investment suitability assessment by an independent investment adviser, who has a fiduciary duty to the investor. This excludes the General Partner or Investment Advisor of the proposed investment from acting in this capacity. The independent investment adviser may be state or SEC registered. The professional holds a responsibility of performing basic due diligence in investigation of the proposed investment, and signing the subscription document as the advising representative.

For sophisticated investors:

For investors that prefer to make their own investment decisions, they have the opportunity to sit for the Series 65 exam and register at a state level as an investment adviser without any clients other than oneself. These investors give proof of demonstrating a minimum level of knowledge required by those that are available for hire. The Series 65 exam should include an enhanced section on private investment companies and basic due diligence requirements expected from an investment adviser.

Benefits

For non-sophisticated investors, the independent investment adviser would certainly cover the suitability, risk tolerance, possibility of economic loss, possible tax consequences, verify independent fund audits, as well as, provide records of the client engagement.

For sophisticated investors, they are free to invest as long as they meet other “accredited investor” qualifications.

Non-SEC registered pools may find enough incentive in this restriction to accelerate SEC registration for access to investors that do not want to engage an investment adviser.

The General Partner of the investee fund can verify the registration of the investment adviser through SEC IARD.

Proposed Changes

Assuming the final rule includes the \$2,500,000 portfolio level requirement as a surrogate for investing sophistication rather than use of an independent investment adviser, I suggest that a qualifying “accredited natural person” is someone who is:

- A director, executive officer, general partner of an active state registered or SEC registered investment adviser OR
- has a \$2,500,000 investment portfolio

AND

- Has an annual income of \$200,000 individually or \$300,000 with their spouse OR,
- a New Worth of \$1,000,000 individually or jointly with a spouse.

2. Inflation Adjustment or Ability to Bear Economic Risk

“inflation, along with the sustained growth in wealth and income of 1990s, has boosted a substantial number of investors past the “accredited investor” standard.”

The proposal to establish the second tier qualification of \$2,500,000 investment portfolio in addition to clearing the \$1,000,000 net worth hurdle will severely penalize millions of small hedge fund investors. Small investors should not be blocked from professionally managed investments based solely on the size of their investment portfolio.

They should not be put at a disadvantage for previous prudent decisions to build and invest a significant portion of their wealth in a primary, secondary residences, and especially investment in real estate supporting business operations and employment; particularly, when the current tax code and inflationary spending policies of the government has made the real estate investment a logical and safe investment choice to build wealth and fight inflationary pressures.

I believe that any investment portfolio hurdle will result in a number of investors that will secure loans against real estate equity in order to enlarge their investment portfolio to meet the proposed portfolio level. This move does not change their net worth. The determined investor would be tempted to leverage their safe assets to provide an avenue for investment in a riskier alternative investment. A motivated investor would not be forestalled by the portfolio hurdle, but consider it a reasonable risk to borrow from a home equity line of credit at 7 to 8% to get a return in excess of 15%. It would take a single cash transfer to a brokerage account.

From my perspective, adding the portfolio level requirement does not do much more than encourage change in asset profiles and enlarges a liability side of the personal balance sheet. The pertinent question related to this point is Ability to Bear the Economic Risk.

The ability to bear economic risk, the risk profile of the investor and the investment’s risk characteristics determine the suitability of investment. Hedge funds range from straightforward long/short equity funds, which are not much more than a “managed account” comprised of multiple investors, to very complicated derivative based capital infusions for private or public companies, to fund of funds which effectively diversify

risk and select managers based on professional knowledge and judgment. The investment risk characteristics vary greatly. The initial subscriptions range from \$10,000 up to several million dollars. Depending on the size of the investment, a \$1,000,000 net worth may be ample financial cushion or a \$2,500,000 investment portfolio may not be sufficient.

The difficulty with this issue is the correct hurdle is not arbitrary. It is probably best addressed through the investment suitability approach discussed above.

The simple answer is “if you cannot afford to lose the entire amount of the investment then do not invest”, or possibly, a natural person’s investment in a single 3(c)(1) company cannot exceed more than 10% of net worth; both very hard to establish as a regulation and subject to a wide range of interpretation.

The text states the original \$1,000, 000 net worth level is roughly equivalent to \$1,900,000 million net worth today. This means an approximately 50% devaluation in the purchasing power of our currency and our U.S. dollar based investments over the last twenty five years.

It is probably appropriate to increase the original “accredited investor standards” to reflect the reality of current purchasing power levels; however, I believe there is not a need to double the standards. I believe most investors in 2007 are much more investment knowledgeable than in 1982. The proliferation of Internet based trading and information has risen the sophistication of most investors that are “inflation millionaires”.

Benefits

Given my commentary, I suggest the following:

Abandon the \$2,500,000 portfolio requirement. This eliminates an unnecessary hurdle.

Set Income level at the \$300,000, individual, and \$450,000, joint, this restricts investment to those that are assumed to generate enough cash flow to recover more quickly from a loss.

Set Net Worth limit to \$1,500,000. This adjusts for over 50% of the inflation change, allows a larger number of small investors to participate, and matches the restriction required by the Advisers Act regarding assessing performance based compensation. Assuming that an investor should not bet the house then this limit should be net of any real estate assets that are not business, investment or rental properties as defined within the IRS code. This effectively reduces the number of investors elevated to accredited status by the price appreciation of their primary, and secondary, or other personal properties.

Provide the alternative for investors to give proof of demonstrating a minimum level of knowledge required by professional advisers. The Series 65 exam should include an

enhanced section on private investment companies and basic due diligence requirements expected from an investment adviser.

Proposed Rule Change

- Has an annual income of \$300,000 individually or \$450,000 with their spouse
OR,
- a Net Worth of \$1,000,000 individually or jointly with a spouse.
OR
- A director, executive officer, general partner of an active state registered or SEC registered investment adviser

Requesting a Point of Clarification

During creation of the final rule, it would be helpful to provide a determination on the following question assuming the following standard continues forward:

- Any director, executive officer, or general partner of the issuer of the securities being offered or sold, or any director, executive officer or general partner of a general partner of that issuer is accredited.

Is that director, executive officer, or general partner considered an “accredited natural person” free to invest in any other investee hedge fund as an individual?

I would consider such a person to sophisticated and able to bear the economic risk assuming they meet the original “accredited person” standard.