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Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: File Number S-7-25-06/Release No. 33-8766; IA-2576

Dear Sir or Madam:

We submit these comments in response to the Commission's request for comments contained in the above-referenced Releases (hereinafter, the "Proposing Release").   We submit these comments on our own behalf and not on the behalf of any client or clients, and have received no compensation, direct or indirect, with respect to these comments.

Our law firm represents hedge funds, investment advisers, commodity advisers, and other participants in the financial markets.   Our comments reflect the experience of our firm's members in serving clients engaged in these activities. That experience, dating to the 1980's, reflects an enormous increase in the number of hedge funds.[1]

The Proposing Release contains two distinct sets of proposed rules:

1. Rules clarifying the Commission's authority to enforce antifraud rules against all investment advisers, whether registered with the Commission or not. These proposed rules are intended to dispel uncertainty in light of the overruling of certain regulations by the United States Court of Appeals for the District of Columbia Circuit.[2]

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[1] See Pellegrino & Lorence, "Use of Derivatives by Hedge Funds (Part 1)," 2 Derivatives Finl. Prod. Rep. 6 (Nov.. 2000); (Part 2), 2 Derivatives Finl. Prod. Rep. 18 (Dec. 2000). This article offers an explanation of the origin of the term "hedge fund," a term which is employed in the Proposing Release without definition or citation to authority. Nonetheless, for simplicity, we adopt the term "hedge fund" rather than "investment company exempt from registration under Section 3(c)(1)," a description based upon the governing rules of law.

[2] See *Goldstein v. Securities and Exchange Commission*, 451 F.3d 873 (D.C. Cir. 2006) (hereinafter, "*Goldstein*"). In brief, the Commission's actions in promulgating regulations (see 69 Fed. Reg. 72,054, Dec. 10, 2004) revising the definition of "client" of an investment adviser under the Investment Advisers Act of 1940 were held to be "arbitrary" because the Commission attempted to overrule the clear Congressional intent underlying the definition of "client."   We demonstrate herein that the Proposing

2. Rules drastically amending existing rules governing the definition of "accredited investor" with respect to qualification for exemption from registration as an investment company under Section 3(c)(1) of the Investment Company Act of 1940 ('hereinafter, the "ICA").

We commend the Commission's proposals with respect to the antifraud rules and have no further comment in this respect.

With respect to the proposed amendments to "accredited investor," we offer the following comments in the expectation that the Commission will withdraw the Proposing Release and issue new proposed rules that are not intended to be subject to the same infirmities (e.g., "arbitrary") as the Court of Appeals found in *Goldstein.*

We commend the Commission on its desire to better protect investors from perceived risks associated with hedge fund investments. However, as discussed herein, we question whether the Commission's present efforts represent a rational and defensible way to achieve this objective, particularly when compared to alternative approaches that the Commission has not sought to pursue. This submission sets forth a description of the relevant proposals and then presents our comments on these proposals. We conclude by providing our thoughts on an alternative approach to investor protection that we expect would be less susceptible to challenge.

I. Proposed Rule Section 230.216 "Accredited investor definition for investors in certain private investment vehicles"

In practical effect, qualification for exemption from registration as an investment company under Section 3(c)(1) of the ICA is not determined by statutory rules, but, rather, under regulations promulgated by the Commission, popularly known as the "Regulation D" exemption. As Section III of the Proposing Release notes, the critical provisions of the present definition of "accredited investor" under Regulation D have remained essentially unchanged since 1982. Since 1982, the Congress has made only one important change to the regulatory framework for hedge funds: the enactment in 1996 of Section 3(c) (7) of the ICA, which provides that a qualifying hedge fund may have up to 499 investors without having to register with the Commission, provided that all investors meet a new statutory definition, "the qualified purchaser."

Current Regulation D standards require that the investor meet either an income or a net worth standard. The net worth standard is $1 million (which can be joint net worth if spouses invest jointly); the income test is $200,000 ($300,000 if spouses invest jointly). The net worth test is a calculation in which the fair market values of all assets are added together, and then all liabilities are subtracted. Thus, the net worth calculations have from inception included the net worth of an investor's home or homes and real estate used in a trade or business or held for investment.

Release's second prong ("accredited investor") is vulnerable to the same result, "arbitrary" rulemaking, as was obtained in *Goldstein.*

The proposed rules would layer upon the existing Regulation D standards a second qualification, effectively $2.5 million of net investments, which is proposed to be adjusted once every five years for inflation (commencing on April 1, 2012). Proposed Rule Section 230.216 contains a complex definition of investments for purposes of qualification under the $2.5 million test.

The Proposing Release states that when Regulation D was adopted in 1982, approximately 1.87% of U.S. households met accredited investor status. The current value, after giving effect to inflation, of that $1 million in 1982 dollars is $1.9 million today. The Commission, however, does not propose to return to the $1 million level (in 1982 dollars), which would merely be the updated value of a test that has been employed for 25 years, despite the fact that this test is relatively simple and easy to use.

Rather, the Commission proposes to impose a new percentage of households' cap, of 1.3%, based on a $2.5 million of investments level. The Proposing Rule provides a rationale for the contention that the protection of the investing public requires the $2.5 million investments test because:

"By incorporating the proposed requirement for $2.5 million of investments owned by the natural person at the time of purchase, that percentage [the 1982 percentage of U.S. households of 1.87%] would decrease to 1.3% of households that would qualify for accredited natural person status, a percentage below 1982 levels**. We believe that this result is appropriate given the increasing complexity of financial products, in general, and hedge funds, in particular, over the last decade.** In addition, we note that the proposed level is less than required for qualified purchasers in 3(c)(7) Pools. We believe that the proposed amount therefore would establish a bright-line standard that addresses our concerns about the increase in individual wealth and income . . . ." (emphasis added).

Moreover, the Proposed Rules would exclude from the qualifications the value of an investor's residences, place(s) of business and real estate used in connection with a trade or business, and real estate. The justification is stated in the Proposing Release at III(B):

"Moreover, the value of a person's personal residence or place of business, or real estate held in connection with a trade or business, bears little or no relationship to that person's knowledge and financial sophistication."

No authority is offered by the Proposing Release in support of any of the mere naked assertions put forward therein. We submit that a change from a long-standing rule (here, of 25 years' standing) requires something far more convincing than conclusory language.

1. We think it most regrettable that the Commission views as a problem that the investing public has so much greater wealth, and more valuable homes, today, than 25 years today. The Commission's concern that widespread increase in prosperity is a problem that needs to be solved by greatly increasing Governmental rule-making is so

fallacious that merely to state it is to recognize its absurdity. The Commission's stated goal of substantially reducing the number of U.S. households qualified to invest in hedge funds, not just under current law, but even fewer than would have been qualified in 1982 (long prior to the explosion in prosperity that has the Commission so worried) is not supported by any rationale that the Commission has articulated..

Moreover, the choice of $2.5 million of investments, which is 50% of the level for a 3(c)(7) funds, appears to be simply an arbitrary attempt to "split the baby" between $0 and $5 million. As with all arbitrary decisions, there is no apparent policy reason justifying this proposed change; e.g., the 1.3% of U.S. households level has no reference point in the ICA, Regulation D, or anywhere else in the Proposing Release.

We challenge the Commission's apparent justification for the proposed rules that financial products, including hedge funds, are more complex today than they were 10 years ago. The Commission's assertions fail utterly to comport with the realities of today's investing public. The Commission's position fails to take into account the fact that increases in prosperity are a reflection of increases in levels of education and sophistication among the investing public.

There are many disappointing inequalities in the distribution of wealth and educational levels in our country. Nonetheless, it is irrefutable, and the Proposing Release accepts as fact, that the universe of potential hedge fund investors has increased over the past 25 years not only as a percentage of the U.S. adult population, but in absolute terms as well. This should be a cause for celebration, not, as the Commission sees it, a cause for alarm. Although the Proposing Release refers to what the Commission perceives as increased complexity in financial products and hedge funds, the Proposing Releases ignores the increase in educational levels that is a concomitant to the very substantial increase in prosperity that has alarmed the Commission.

Moreover, the Proposing Release fails to take into account the enormous increase in information about the financial markets (and all other things) now available to the investing public, through the internet and other sources. In 1982, sources of publicly available information were largely limited to print media such as the daily newspaper or Barron's Magazine, which information was necessarily stale. A 1982-vintage investor wanting current information had to call his or her broker during business hours and make inquiries about the proposed investment while the broker sought out information on what would today be a laughably "antique" computer system. Moreover, the revolution wrought by the Commission through its EDGAR filing system was many years in the future. Surely the Commission does not contend that EDGAR has made the markets more complex, rather than less complex, by affording retail investors the timely access to corporate filings that were previously restricted almost entirely to industry insiders.

2. If the Commission insists on amending Regulation D applicable to hedge fund investors, we suggest it be amended to provide for the inflated 1982 value of $1 million, which is $1.9 million, rounded up to $2 million of net worth. This would greatly simplify the application of the rules, while preserving the basic tests of 1982. The fact that a

higher percentage of U.S. households meets that inflated amount today than was true in 1982 appears to us to be a good thing, not a bad thing to be curbed back, as the Commission would have it.

Moreover, from the standpoint of administrative simplicity and burden upon the investing public, hedge fund managers and other participants in the hedge fund industry, an updating of current rules, rather than their replacement by something new and complex is the course that would be least vulnerable to challenge in the Court of Appeals. By proposing new and complex rules, the Commission lays itself open to a fourth challenge to its rule making in less than two years. Having lost the first three challenges, we submit that a more conservative course than that charted by the Proposing Release is advisable.

3. With respect to the Proposing Release's claim that investors need to be protected from increasingly "complex" financial products, we note that the most significant failures with respect to financial markets in general and hedge funds in particular arose from entities that were regulated by the Commission, the Commodity Futures Trading Commission, and self-regulatory organizations. The last ten years have seen catastrophic failures by, inter alia, Refco Securities, Inc., Bayou, Long-Term Capital Management, Philadelphia Alternative Asset Management Co., and Amaranth. Nothing in the Proposing Release would have changed the result in any of these catastrophic failures; moreover, there is nothing in the Proposing Release that is going to prevent the next catastrophic failure.

We find no basis for the Commission's view that hedge funds are inherently more complex than other private placements and therefore should be available for investment only by the wealthiest of the wealthy. At a minimum with respect to hedge funds offered by SEC-registered investment advisers, if not also those offered by state registered investment advisers, far greater protection and transparency is afforded to hedge fund investments than investments in other, non-financial-based private offerings. Can it truly be said that a privately-placed investment in a hedge fund management company is simpler, and therefore should be open to any accredited investor, than is an investment in the very fund managed by such investment company. Yet this illogical result would be obtained under the proposed change.

We also note the illogicality of the proposed rules which appear to be based on the view that investments in a hedge fund managed by a registered investment adviser (whether registered with the Commission or a state regulator) are equally "risky" with investments in hedge funds managed by non-registered investment advisers, because the same standards for who can invest apply. The Commission appears, however inadvertently, to concede that its regulation of hedge fund managers provides no benefit to the investing public.

II. Transition and Grandfathering Rules

The Proposing Rules would significantly decrease the universe of accredited investors from the effective date when final rules are issued. The release published on December

10, 2004, that was at issue in *Goldstein*, contained significant grandfathering and transition rules, enabling affected persons to deal with the challenges posed by those rules. The Proposing Release does not provide any transition or grandfathering rules, which we believe to be most regrettable. The Commission's failure to explain this abrupt change with respect to the rights of affected persons to deal with new rules is, by itself, grounds for the Commission to withdraw, and re-think, the rules contained in the Proposing Release.

The Proposing Release states:

"We note that our proposed rules would not grandfather current accredited investors who would not meet the new accredited natural person standard so that they could make future investments in private investment pools, even those in which they are currently invested. Commenters are asked to comment on whether such grandfathering provision is necessary and/or appropriate and why."

The effect of the proposed rules, if they are issued as final rules in the same form, can be illustrated by the following examples:

EXAMPLE 1. Continuation of Current Law. Grandmother A has been a limited partner in Hedge Fund Alpha, L.P. since its organization in 2002. Hedge Fund Alpha has 99 investors, of whom 35 are non-accredited. Hedge Fund Alpha, L.P. is a Delaware partnership that is qualifies for exemption for registration as an investment company under ICA Section 3(c)(1); Grandmother A was, and remains, an accredited investor from 2002 to date. Grandmother A's original capital contribution has increased to $700,000 (after giving effect to fees, expenses and incentive re-allocation of profits to the general partner of Hedge Fund Alpha, L.P.). Under current law, Grandmother A contributes $250,000 of additional capital to Hedge Fund Alpha, L.P. , which does not affect Hedge Fund Alpha, L.P.'s qualification as a Section 3(c)(1) fund.

EXAMPLE 2. Final Rules Based on the Proposed Rules. Assume that Grandmother A does not meet the new definition of "accredited investor" and contributes $250,000 to Hedge Fund Alpha, L.P. With respect to this additional contribution Grandmother A is classified as a non-accredited investor. Hedge Fund Alpha, L.P. loses its qualification as a Section 3(c)(1) fund because it has accepted a capital contribution from a 36th non-accredited investor, in violation of Regulation D.

Example 2 demonstrates the inherent irrationality of the proposed rules' approach to grandfathering. Any existing investor who met the current definition of accredited investor would not make an additional contribution to that fund unless they were satisfied with the fund's results and governance. To reclassify them as non-accredited with respect to the same fund because they desire to make a further investment is to protect them against a supposed "evil" that does not exist. This approach to rulemaking, which is colloquially known as the "Nanny State" would be employed by the Commission to protect individuals from harms that individuals are best left to judge for themselves.

1. We suggest that existing accredited investors in a hedge fund retain that status as measured by current law standards.

2. We suggest that any final rules apply only to investors in a fund who enter on or after the sixtieth day after the day the final rules are issued. This will ensure a much more orderly transition period for implementation of any final rules than the "cliff rule" contained in the Proposing Release.

III. Other Items for Which Comments Are Solicited

A. Proposed Exemption for Venture Capital Funds

The Proposing Release at III(B)(4) requests comments on the proposed exclusion of venture capital funds from the definition of "private investment vehicles" to which the proposed standard of accredited investor would apply. We fail to understand the rationale for the proposed exclusion. The purported reason for the proposed amendment to "accredited investor" for hedge funds is that the financial markets and hedge funds, have become increasingly more complex. We submit that the same rationale certainly applies to venture capital funds, which are vastly more complex today than they were previously, because of the expansion of industries into which venture capital funds invest. If anything, investing in illiquid, difficult to value securities makes venture capital funds much more complex than the overwhelmingly share of hedge funds.

The Commission's proposal to afford venture capital fund managers greater access to the non-accredited investor universe than to hedge fund managers is, we submit, perverse logic at best.

B. Whether "Accredited Investor" Should Apply to Employees of the Adviser

The Proposing Release at III(B)(2) requests comments on whether employees of an investment adviser to a hedge fund should be subject to the same "accredited investor" standard that would apply to investors that are not affiliated with the investment adviser. As the Proposing Release notes, it is common for employees to participate in a hedge fund as investors, or indirectly, through participation in the hedge fund's manager. In our experience, this type of arrangement is common throughout the business world, not merely in hedge funds. Participation by employees is, we submit, salutary because it binds the employees' interests to the interests of the investors.

We submit, further, that there is no class of potential investor less in need of the protection of the Commission's rule-making power than the manager's own employees.

C. Cost Benefit Analysis

The Proposing Release at VI(B)(2) (cost-benefit analysis) asserts that the proposed revision to "accredited investor" would benefit those investors who would meet the new definition, "by increasing competition among 3(c)(1) Pools for their investment money.

Such competition may result in lower fees."   We submit that the Commission is grasping at straws here.

Our experience indicates that no comparable reduction in fees occurred when Section 3(c)(7) funds came into existence ten years ago. Thus, the fee levels in Section 3(c)(7) funds are comparable to those in Section 3(c)(1) funds, even though the universe of qualified purchasers is much smaller than the universe of accredited investors, and that qualified purchasers are wealthier and arguably in a much better position to demand lower fees than accredited investors. The fact that the Commission has not demonstrated that qualified purchasers have obtained more competitive fees indicates that the Proposing Release is wide of the mark about the supposed benefits of the proposed rules.

Rather, we are confident that if the proposed rules are issued as final rules, there will be increased complexity in the administration of hedge funds, and fewer funds being organized – all of which will be to the detriment of investors, who will see the universe of choices cut back.   Given the Proposing Release's failure to demonstrate any harm to investors caused by the 25 year-old definition of accredited investor, a compelling argument to support the need for drastic change certainly has not been made. Moreover, the largest problems have been "blow ups" at large funds, problems that are not addressed in the Proposing Release and problems for which the Commission has no apparent remedy. Visiting harsh rules upon the smaller, entrepreneurial hedge fund manager seems an unworthy response to the Commission's failures with respect to catastrophes at Section 3(c)(7) funds.

D. Effect on Small Entities and Capital Formation

The Proposing Release at VII(B)(7) and VIII solicits comments on the number of small entities that would be affected by final rules and the effects on capital formation.
We submit that the effect of final rules would be to limit the universe of investment choices for managed investments available to investors who are not Section 3(c)(7) qualified purchasers. These vehicles are: managed accounts (i.e., a account at a brokerage firm for a single investor as to which an investment manager has discretionary authority to direct the trades); a non-exempt investment company (i.e., a mutual fund or a closed-end fund); an ETF (exchange traded fund); a hedge fund; or a commodity pool.
The practical effect of final rules would be to increase the amount of mutual fund and closed end fund shares purchased – that is, the money that would have been invested in a Section 3(c) (1) fund is going to be invested somewhere, and the most likely recipient would be mutual funds and closed–end funds.

The barriers to entry in the mutual fund and closed end funds are substantial. The Commissions' own processes guarantee that the fledging manager must hire counsel whose expertise does not come cheaply, administrators, etc. The costs of organizing and annual administration of a mutual fund are extensive. However, the compensation to a successful hedge fund manager, based on a percentage of profits (as to qualified clients) is substantially greater than the compensation of mutual fund manager.

The obvious result, and we submit, the obvious intent, of the Commission in issuing the Proposing Release, is to benefit the mutual fund industry by dramatically decreasing the number of new, smaller entrepreurial hedge funds. The Commission's stated goal in reducing the universe of accredited investors to below the percentage of households in 1982 is confirmatory evidence of this intent.

The Commission has put forth no evidence that the decrease in competition contemplated in the Proposing Release is necessary to protect investors and the financial marketplace. We note that the Commission's regulation of the mutual fund industry has been something less than an unalloyed success. Moreover, the Commission has furnished no rationale for its obvious intent to benefit the mutual fund industry. Rather, the Commission's attempt to turn back the clock, despite all of the many innovations (e.g., electronic trading through the internet, ETFs) seems perverse to us.

We submit that the proper role of the Commission is to increase competition, not to limit competition so as to benefit one segment (i.e., mutual funds).

Conclusion

The Commission suffered a crushing defeat in *Goldstein.* The Proposing Release suffers from many of the same infirmities that led to that defeat. We cannot understand why the Commission did not simply update the 1982 value for $1 million of net worth into current dollars. The Commission's desire to create a new definition of accredited investor for reasons the Commission is unable to articulate, is most regrettable.

We suggest that the period of uncertainty that followed the Commission's defeat in *Goldstein* is likely to be repeated upon a challenge to final rules based upon the Proposing Release. We urge the Commission to adopt a more measured approach than that provided in the Proposing Release.

Yours Respectfully,

/s/ /s/

Roger D. Lorence, JD, LLM (Taxation) John V. Schrier, JD, LLM (Taxation)