324

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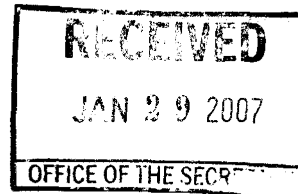

January 23, 2007

Nancy M. Morris
Secretary
Securities and Exchange Commission
100 F Street NW
Washington, DC 20549-1090

Re: File Number S7-25-06

Dear Ms. Morris:

We write in response to the Commission's request for comments concerning proposed Rules 216 and 509 under the Securities Act of 1933 ("Securities Act").

In view of the time that has passed since the adoption of Regulation D in 1982, and the cumulative effect of inflation on the rigor of the original income and net worth standard applicable to natural persons, we support in principle the Commission's decision to reconsider the "accredited investor" standard in view of its original purpose. We believe, however, that the $2.5 million in "investments" requirement of the proposed "accredited natural person" definition is arbitrary and too high. As an alternative, we respectfully submit that the interests of the public and the Commission would be better served by establishing a "percentage of net worth" standard.

Proposed Standard Bears No Relation to Investor Sophistication

Flaws in the current proposal can be illustrated by example. Consider a natural person with a portfolio of real estate (excluding his or her residence) valued at $10 million and a securities portfolio of $1.5 million. If this person is not engaged *primarily* in the business of investing, trading or developing real estate, the value of his or her real estate portfolio will be disregarded when calculating the level of "investments" held. Although this investor has a net worth, exclusive of his or her residence, of $11.5 million and is surely a sophisticated investor, he or she would not qualify as an accredited natural person. In contrast, another investor with a quarter of that net worth could qualify solely because he or she has historically opted to hold that net worth in securities, rather than some other form. Consequently, the first investor would for all practical purposes be prevented from investing a single dollar in hedge funds while the second investor could invest substantially all of his or her net worth in such funds.

There is further uncertainty in the proposed rule in connection with investments by entities. Consider natural persons who have pooled their funds into a two-person partnership. As long as that partnership meets the other criteria under Regulation D—it was not formed for the purpose of investing in a particular hedge fund—the partnership could be an accredited investor under rule 501(a)(8) even if each of its partners has a net worth of only $1 million.

No Evidence of "Retailization" of Hedge Funds to Support the Proposed Rules

We anticipate that the Commission might take the view that the foregoing example is an exception, rather than the rule, and the need nevertheless remains to restrain the retailization of hedge funds. In our view, if the proposal is designed to address the "retailization" of hedge funds, it seems to be a solution in search of a problem. We note the 2003 Staff Study ("Study") concluded: "[t]o date . . . the staff has not uncovered any evidence of significant numbers of retail investors investing directly in hedge funds."[1] Elsewhere, the Study also found that there was "no evidence indicating that hedge funds or their advisers engage disproportionately in fraudulent activity."[2]

The proposal is silent as to why a different conclusion was reached in 2006 and what, if anything, has changed since the 2003 Study. Our firm is one of the very few firms in the United States that serves investment advisers alone (and, by extension, many hedge fund managers). In our experience, there has been no detectable shift toward retailization. Indeed, most of the new funds we establish and represent launch with a combination of the adviser's own capital and capital from so-called "friends and family." Absent a change in rule 2(a)(51) to the eligibility requirements applicable to "knowledgeable employees," which we do not advocate, the former investments will still be permitted. The interests of the latter (and other natural person investors) can be equally well-protected by taking steps to insure their investments in hedge funds are not disproportionate relative to their net worth and ability to lose their investment (which is demonstrably as great, if not greater, in venture capital funds. It seems inconsistent, therefore, that they been explicitly excluded from the proposed rule).

We respectfully remind the Commission that the U.S. Court of Appeals in *Goldstein, et al. v. Securities and Exchange Commission* invalidated the hedge fund registration rule in part due to shortcomings in the rulemaking process. The Commission cited, as justification for the proposed hedge fund rule, a rise in the amount of hedge fund assets, indications that more pension funds and other institutions were investing in hedge funds, and an increase in fraud actions involving hedge funds. The court pointed out that all of the foregoing might be true (while noting that the dissenting commissioners "doubted it"), but it also found 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."[3] What evidence has the Commission found to support the changes in the conclusions it articulated in the 2003 Study? If there is evidence, it is not cited (or even mentioned) in the Release thereby making it impossible for the public to scrutinize and comment on it.

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

[2] *Id.* at p. 73.

[3] *Goldstein v. Securities and Exchange Commission*, 451 F.3d 873 (D.C. Cir. 2006).

In light of the foregoing, we respectfully ask the Commission to direct the staff to identify what has changed since the publication of the Study and substantiate it with empirical evidence. Based on our extensive experience, we are not confident the evidence exists.

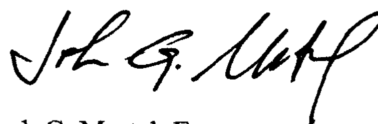
Percentage of Net Worth Test Would Protect Individual Investors

As an alternative to the current proposal, we ask the Commission to consider a "percentage of net worth" test to establish eligibility as an accredited natural person. We propose establishing that percentage in the range of 15% of a person's net worth (excluding other hedge funds).[4] Under such a test, a natural person that is an accredited investor under today's eligibility standards could invest no more than $150,000 in hedge funds (collectively), and hedge fund investments by a natural person whose net worth is $2.5 million would be limited to $375,000. To us, this is more sensible than excluding all investors that do not meet an arbitrary minimum "investments" test, and inviting others to invest any percentage of their investment portfolio, theoretically including all of it, in hedge funds.

We appreciate the opportunity to comment on the proposed rule and thank you for your attention to the foregoing.

Sincerely yours,

THE SECURITIES LAW GROUP, LLP



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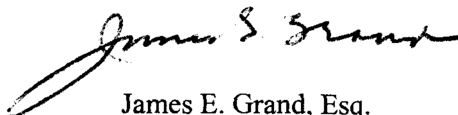

James E. Grand, Esq.

Enclosures (2)

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[4] We note that some states use a percentage of net worth test in connection with certain of their private offering exemptions. *See, e.g.*, Cal. Corps. Code Section 25102(n): individual's investment cannot be more than 10% of net worth.