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March 1, 2007

VIA ELECTRONIC MAIL

Jonathan G. Katz
Secretary
U.S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549-0609

Re: File No. S7-25-06: Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles; Accredited Investors in Certain Private Investment Vehicles

Dear Mr. Katz:

We are submitting this comment letter in response to the request for comments made by the Securities and Exchange Commission (the "Commission") with respect to the proposed amendments to Rule 206(4) under the Investment Advisers Act of 1940, as amended (the "Advisers Act) and the proposed amendments to the definition of "accredited investor" under Rule 501(a) of Regulation D and Rule 215 of the Securities Act of 1933, as amended (the "Securities Act").[1] (We refer to such Commission's proposals as the "Proposed Rules" and the proposing release relating thereto, the "Release").

In our view, there are several aspects to the Proposed Rules with which we respectfully disagree and, as to others, request that the Commission provide clarification. This letter speaks to the proposals with regard to the Anti-Fraud Rule first and then to those regarding the eligibility standards for hedge fund investors. Finally, we reference certain policy implications for the Commission's consideration.

[1] Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles; Accredited Investors in Certain Private Investment Vehicles Release No. 33-8766, File No. S7-25-06 (December 27, 2006) (the "Release").

I. Anti-Fraud; Proposed Rule 206(4)-8.

(a) Scienter Should be Required Under Proposed Rule 206(4)-8.

(i) *Statements by the Adviser.* The Commission states that, unlike violations of Rule 10b-5 under the Securities Exchange Act of 1934, as amended (the "Exchange Act"), the Commission would not need to demonstrate that an adviser violating Proposed Rule 206(4)-8 acted with scienter.[2] We believe that as a matter of policy the text of 206(4)-8 should require proof of scienter on the part of the Commission. Many advisers to private investment vehicles have complicated and lengthy documentation including private offering memoranda, account statements, marketing materials, periodic newsletters and investor communications, and financial statements. Generally, these materials are prepared with the assistance of legal, audit, administrative, tax and other professionals who are more familiar with the intricacies of these materials. In the event, for example, the audited financials of an adviser failed to include certain expenses deemed to be material, it is only fair to hold the adviser liable where it was actually aware of the omission.

The Commission cites the decision of the United States Court of Appeals, District of Columbia Circuit in *SEC v. Steadman*[3] in support of its proposition that scienter not be required. That case involved actions by the investment adviser to a mutual fund registered under the Investment Company Act of 1940, as amended ("Company Act").[4] Private investment vehicles exempt from registration pursuant to Sections 3(c)(1) or 3(c)(7) of the Company Act are not subject to many of the same rules and regulations as registered mutual funds and properly so, especially in light of the Commission's decision in the Proposed Release to increase eligibility standards, at least for Section 3(c)(1) funds. Investments in mutual funds are available to a larger universe of investors who do not need to satisfy the eligibility requirements that investors in private investment vehicles must satisfy. This is predicated upon the belief that mutual fund investors are less financially sophisticated and require a higher level of protection. We agree that investment advisers, like any other professionals, should be held accountable for failure to use reasonable care. However, to be held accountable for inadvertent errors, including items that looking back over time may appear erroneous, even if thought in good faith to be true when published, appears quite unfair and seems to us to be a burden that is virtually impossible to meet. Accordingly, we believe the Commission should distinguish between the standard required to prove liability of an investment adviser to mutual funds as opposed to an adviser to solely private investment vehicles.

(ii) *Statements Made by Third Party Providers.* In addition, we ask that the Commission clarify whether such investment advisers would also be liable for statements made to investors or prospective investors by third party service providers, solicitation agents, placements agents, marketers or other such service providers that, while acting as an agent of the adviser, make statements that exceed their agency authority. The issue of scienter becomes even more urgent in this case. We believe it is important that the Commission be required to prove the investment adviser had actual knowledge such statements were being made.

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[2] *Id.* at 12.
[3] *SEC v. Steadman*, 967 F.2d 636, 647 (D.C. Cir. 1992).
[4] *See id.*

(b) The Commission Should Clarify its Reasoning for Limiting the Scope of Proposed Rule 206(4)-8 to Funds Exempt Pursuant to Section 3(c)(1) and 3(c)(7) of the Company Act.

The Release states that the Proposed Rule 206(4)-8 would not distinguish among types of pooled investment vehicles and is designed to protect investors both in investment companies and in pools that are excluded from the definition of investment company under Section 3(a) of the Company Act by reason of either Section 3(c)(1) or 3(c)(7). With the exception of stating its belief that most privately offered pooled investment vehicles are organized under Section 3(c)(1) or 3(c)(7), the Commission provides no support for limiting the application of Proposed Rule 206(4)-8 solely to Section 3(c)(1) and 3(c)(7) companies. We are not persuaded that, for instance, an adviser to a company making small loans,[5] purchasing mortgages and other interests in real estate,[6] or engaging in underwriting and distributing securities issued by other persons[7] should not be subject to the same anti-fraud rules as a Section 3(c)(1) or 3(c)(7) company. As such, we request that the Commission provide clarity as to why it believes an adviser to the above-referenced types of investment vehicles should not be subject to Proposed Rule 206(4)-8.

II. Eligibility; Proposed Rules 509 and 216.

Under the exemption provided by Section 4(2) of the Securities Act and Regulation D promulgated thereunder, privately offered securities are exempt from registration in accordance with Section 5 of the Securities Act. Offerings of securities conducted in accordance with the "safe harbor" criteria set forth in Regulation D are considered nonpublic offerings that comply with the private offering exemption of Section 4(2). Although the proposed definition of "accredited investor" in Proposed Rules 509 and 216 is identical, we limit our discussion below to the amendments to Regulation D. Notwithstanding the foregoing, our discussion should be read to apply to both Proposed Rules.

In general terms, a natural person is considered to be an "accredited investor" where 1) that person's individual net worth, or joint net worth with that person's spouse, at the time of the purchase of a security, is $1,000,000, ("net worth test") or 2) that person has individual income that exceeds $200,000 in each of the two most recent years or joint income with that person's

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[5] Pursuant to Section 3(c)(4) of the Company Act, any person substantially all of whose business is confined to making small loans, industrial banking, or similar businesses shall not be considered an investment company within the meaning of the Company Act.

[6] Pursuant to Section 3(c)(5) of the Company Act, any person who is not engaged in the business of issuing redeemable securities, face-amount certificates of the installment type or periodic payment plan certificates, and who is primarily engaged in one or more of the following businesses: (A) Purchasing or otherwise acquiring notes, drafts, acceptances, open accounts receivable, and other obligations representing part or all of the sales price of merchandise, insurance, and services; (B) making loans to manufacturers, wholesalers, and retailers of, and to prospective purchasers of, specified merchandise, insurance, and services; and (C) purchasing or otherwise acquiring mortgages and other liens on and interest in real estate shall not be considered an investment company within the meaning of the Company Act.

[7] Pursuant to Section 3(c)(2) of the Company Act, any person primarily engaged in the business of underwriting and distributing securities issued by other persons, selling securities to customers, acting as broker, and acting as market intermediary, or any one or more of such activities, whose gross income normally is derived principally from such business and related activities shall not be considered an investment company within the meaning of the Company Act.

spouse in each of those years exceeds $300,000, and there is a reasonable expectation of reaching the same income level in the current year ("income test").[8]

Proposed Rules 509 and 216 would significantly impact individuals seeking to invest in 3(c)(1) funds and fund managers seeking to raise capital by defining a new category of accredited investor called "accredited natural person." The effect of Proposed Rules 509 and 216 would be to require natural persons seeking to invest in a 3(c)(1) fund to meet either the income test or the net worth test and own (individually, or jointly with that person's spouse as discussed below) not less than $2.5 million in "investments."

(a) The Proposed Standard for Ownership of at Least $2.5 million in Investments Should be Reduced or Proposed Rules 509 and 216 Revised.

Recognizing the increasing popularity of hedge funds, the Commission has continually sought to review and modify investor eligibility standards as well as the standards for registered investment advisers to charge performance fees. For example, in 1997, the Commission issued a release proposing to revise the client eligibility criteria under Rule 205-3 of the Advisers Act.[9] In the release, the Commission proposed, and later made final,[10] an amendment to Rule 205-3 of the Advisers Act increasing the amounts of the net worth and assets under management tests for "qualified clients" from $1,000,000 and $500,000 to $1,500,000 and $750,000, respectively. The Commission stated that the increase was not intended to reduce the number or alter the types of advisers with which an investor may enter into a performance fee arrangement, but to reflect the effects of inflation on the "qualified client" standard.[11]

According to Office of Economic Analysis ("OEA") estimates cited by the Commission, Proposed Rules 509 and 216 would have the effect of reducing the percentage of households eligible to qualify as accredited investors to 1.3%, as opposed to the 1.87% of households that would have qualified as accredited investors in 1982 and 8.47% of households that would have qualified as of 2003. The Commission states that the decrease in percentage of eligible households below the 1982 levels is appropriate given the "increasing complexity of financial products, in general, and hedge funds in particular, over the past decade".[12]

In our view, the issue here is two-fold: First, it is not clear why the Commission deems it appropriate to have a lower standard of eligibility for an investor being charged performance fees by a registered investment adviser as opposed to those seeking to invest in a 3(c)(1) fund.

Secondly, we believe it is not appropriate to effectively reduce the percentage of eligible households to below the 1982 levels. In the Commission's report on the Implications of the Growth of Hedge Funds,[13] the Commission pointed out that although the "accredited investor"

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[8] Regulation D, Rule 501(a)(5) and (6)

[9] Exemption To Allow Investment Advisers To Charge Fees Based Upon a Share of Capital Gains Upon or Capital Appreciation of a Client's Account Release No. IA-1682, File No. S7-29-97 (November 13, 1997).

[10] *Id.*

[11] *See supra*, note 8.

[12] *Id.*

[13] *Implications of the Growth of Hedge Funds, Staff Report to the United States Securities and Exchange Commission* ("2003 Staff Hedge Fund Report"), available at http://www.sec.gov/spotlight/hedgefunds.htm.

thresholds were established in 1982, the Commission has since had the opportunity to evaluate those thresholds.[14]

As recently as 2001, the Commission stated that "accredited investor" standard "struck the appropriate balance between investor protection and capital formation needs and did not propose changes to the definition." We would suggest that those words are as true today as then and that the approach ought to be to index the income and the net worth test to some external standard like cost of living or inflation rate.

Using estimates based on the OEA's Personal Consumption Expenditures Chain-Type Price Index (as cited by the Commission in the Release), the accredited investor standards as of 2001, adjusted for inflation, would equal approximately $1.4 million (net worth), $280,000 (individual income), and $320,000 (joint income) today. Even assuming the Commission determines to amend the accredited investor standard based upon adjustments for inflation beginning in 1982, the proposed net worth level of $2.5 million in *investments* would be excessive. As stated in the Release, the 1982 standards, adjusted for inflation, would have been approximately $1.9 million (net worth). By increasing the net worth threshold to $2.5 million and excluding, among other things, an investor's interest in its personal residence, the Commission would significantly exceed any adjustment for inflation and can only be seen as attempting to arbitrarily limit the number of accredited investors.

Even if there has been an increase in complexity of financial products utilized by hedge funds and other types of investment vehicles over the past decade, we believe investor's financial and economic awareness has increased markedly to account for the increasing complexity. Moreover, with the advent of the internet, increased availability of financial advisers, increased reporting requirements, regulation and oversight there is significantly more information and protection available to investors than existed in 1982.

Lastly, there now exist far more hedge funds with greater transparency, a significant portion of which implement relatively basic long/short investments in equities. We believe it is better to allow qualified investors to use their discretion as to whether a financial product is appropriate for investment given their level of expertise rather than to exclude them altogether.

Based upon the foregoing, we believe a more appropriate standard for "accredited natural person" would be numbers that approximate $1.5 million (net worth)[15] or $250,000 (individual income), and $350,000 (joint income).[16] By adopting this standard, the accredited investor eligibility requirements would be in line with the standard for qualified clients with respect to the net worth test and would be raised to account for the effects of inflation with respect to the income standard.

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[14] Defining the Term "Qualified Purchaser" Under the Securities Act of 1933, Release No. 8041; File No. S7-23-01 (Dec. 19, 2001).

[15] We believe the net worth standard should be determined in the same manner as the net worth standard for qualified clients (i.e. inclusive of personal residence).

[16] We agree with the Commission's proposal to include adjustment for inflation, although we would propose adjustments occur every ten years as opposed to the Commission's proposal of every five years.

(b) The Proposed Net Worth Standard Should be Based Upon Each Prospective Investor's Aggregate Net Worth.

As noted, above, we favor an accredited investor standard similar to the current standard for "qualified clients" with respect to the net worth test. Qualified clients include natural persons and companies that have at least $750,000 under the adviser's management; or that the adviser (and any person acting on the adviser's behalf) reasonably believes (i) to have a net worth (together, in the case of a natural person, with assets held jointly with a spouse) of more than $1,500,000.[17] Under the National Securities Markets Improvement Act of 1996 (the "1996 Act"), Congress granted the Commission the authority to define the term "investments" for the purpose of Section 3(c)(7) of the Company Act.[18] The 1996 Act also made certain amendments to Section 3(c)(1) of the Company Act, but notably did not amend the financial eligibility thresholds for accredited investor. Thus, there is no indication the "investments" aspect of the qualified purchaser standard was intended to apply to 3(c)(1) funds. Consequently, we believe that as a matter of simplicity and consistency, the Commission's proposed accredited investor net worth thresholds should continue to include a net worth standard inclusive of personal residences.

In the event the Commission decides to adopt the proposed net worth standard based upon each investor's or prospective investor's "investments," we urge the Commission to reconsider certain aspects of the definition for "investments." As noted in the Release, Rule 2a51-1 of the Company Act allows investments held jointly with a spouse or part of a shared community interest to be included for the purposes of determining whether the person is a qualified purchaser under Section 2(a)(51)(A) of the Company Act.[19] In contrast, the Commission proposes that for persons, acting on their own behalf, seeking to qualify as accredited investors, such person may include only fifty percent (50%) of assets held jointly (or other form of shared ownership with that person's spouse). The Commission argues that allowing a prospective investor to include only half of the value of these categories of investments is typical of the division of assets of natural persons and their spouses made for other purposes.[20] We do not agree that it is appropriate to treat jointly held marital assets in this manner while the persons remain married. We believe it is more appropriate to allow natural persons seeking to qualify as accredited investors to include the total value of jointly held assets for so long as they are married. In the event the assets are divided, the person would need to qualify based on the reduced assets if they chose to make an additional capital contribution.

(c) The Proposed Rules 509 and 216 Should Include an Exemption for "Knowledgeable Employees" and should include a grandfathering provision for certain forms of investments.

(i) *Knowledgeable Employees.* We believe it is critical to include a provision for knowledgeable employees. While we appreciate the Commission's desire for some objective

[17] Investment Advisers Act, Rule 205-3(d).
[18] Securities and Exchange Commission: "Privately Offered Investment Companies"; Final rule, Release No. IC-22597.
[19] S*upra* note 1 at 27.
[20] *Supra* note 1 at 28.

standard aimed at limiting eligibility to investors with requisite ability to understand the risks and bear the economic burden of the investment, we question why insiders are excluded. While these persons may not necessarily meet the heightened net worth standard, they should qualify as a result of their financial sophistication, knowledge and experience. Moreover, it is in the interest of other investors that employees of an adviser have a financial interest in the funds they help to manage.

In the Commission's final rule adopting the qualified client standard, the Commission recognized that employees who actively participate in the investment activities of an adviser are likely to be sophisticated financially and do not need the added protection of a fee prohibition.[21] We can see the same recognition for a 3(c)(7) fund as set forth in Rule 3(c)(5) promulgated under the Company Act. Accordingly, we see no reason why the same analysis would not apply to knowledgeable employees of a adviser seeking to invest in a 3(c)(1) fund they help to manage.

(ii) *Grandfathering.* In addition, we believe that further clarification should be provided with regard to investors who made capital commitments to a 3(c)(1) fund when such investor satisfied the eligibility standards prior to the anticipated rule changes. Would such investor be precluded from funding such commitments if they did not meet the new eligibility requirements? We suggest that the grandfather provision be extended to cover investors who have invested in and entered into capital commitments made with respect to a 3(c)(1) fund prior to the adoption of any final rule. As a result, such investors would be permitted to fulfill the term of their capital commitment and continue to invest up to their capital commitment regardless of whether they satisfy the heightened eligibility standard.

Failure to allow investors to fulfill capital commitment obligations would put the investor in the rather untenable position of having to default on its commitment and suffer the penalties that would certainly flow from that event. Additionally, funds that have based their investment structure, trading and/or marketing based upon these capital commitments would be adversely impacted.

(d) The Application of Proposed Rules 509 and 216 to Only 3(c)(1) Funds Appears to be Arbitrary.

In providing an exemption from the provisions of Proposed Rules 509 and 216 for venture capital pools, the Commission points to the role venture capital funds and business development companies play in providing capital and managerial assistance to small businesses.[22] While we agree with this, we also believe hedge funds provide valuable benefits as well. The Commission has requested comment as to whether they should define venture capital funds in terms of their investment objective and strategy (i.e., investing in and developing start-up and early phase businesses) or, alternatively, to define private investment vehicles to include 3(c)(1) funds that do not permit their investors to redeem their interests in the pools within a specified period of time ("holding period").

[21] *Supra* note 9.

[22] *Supra* note 1 at 30.

We believe that applying Proposed Rules 509 and 216 solely to 3(c)(1) funds appears to be arbitrary. Venture capital funds investing in and providing capital to start-up businesses may involve equal if not greater risk than even the most sophisticated hedge fund. Venture capital funds are often investing in highly technical and sophisticated businesses and may provide less transparency to their investors than hedge funds. The prospect of providing start-up capital to new businesses is an inherently risky enterprise. Hedge funds, on the other hand, provide risk and return opportunities not generally available in traditional investment vehicles and can serve as important means of diversification for investors. Additionally, hedge fund returns can provide returns uncorrelated with the equity and bond markets and as such have the unique ability to achieve positive returns regardless of the direction the market is taking. As the hedge fund industry continues to grow, it provides an increasingly important source of liquidity and funding to the financial markets. Consequently, we believe the Commission has failed to provide adequate reasons to distinguish venture capital funds from other types of private investment vehicles and that private investment vehicles should not be placed at a commercial disadvantage.

With respect to the holding period, it is not clear to us that allowing funds with a minimum two-year holding period to circumvent the heightened accredited investor eligibility standard will achieve the sought after investor protection. For example, how are investors, particularly those who are not subject to the heightened eligibility standards of the Proposed Rule 509, benefited by being required to lock-up their investment? This would not only encourage funds to "lock-up" investors and decrease liquidity, but would also allow relatively unsophisticated investors to invest in products they may not be able to get out of. Instead, we ask that the Commission balance the benefits provided by venture capital funds and hedge funds with the desire to provide investor protection by adopting one of the accredited investor standards proposed above. As a result, all types of 3(c)(1) funds would be subject to the higher accredited investor standard thereby ensuring the requisite level of sophistication among investors in all types of products while also allowing a greater number of investors to participate in these financial products.

III. Global Confusion.

In adopting the Exchange Act, Congress created the Commission with the purpose of enforcing and administering the Securities Act.[23] The Securities Act has two basic objectives. First, to ensure that investors have all material information concerning securities that are publicly offered for sale, and second, to prohibit deceit, misrepresentation and other forms of fraud in the sale of securities. We agree it is critical that the Commission is proactive and provided the flexibility to fulfill these objectives and to adapt the rules and regulations to a rapidly changing market. It is not evident to us, however, that the Proposed Rules 509 and 216 will be successful in protecting investors. Rather, it seems that the Proposed Rules 509 and 216, if adopted, would add significant confusion to an already complicated pattern of investor eligibility standards. Consider this: We have in use a number of investor definitions each with the intent of reaching the same conclusion with regard to the investor – sophistication to evaluate and bear the risk of the private placement:[24] In very general terms, at the risk of appearing to oversimplify the

[23] *See* Exchange Act, Section 4.

[24] This also includes the qualified client eligibility standard which is generally designed to ensure investors who are charged performance fees are adequately sophisticated and able to bear the risk of private placement.

definitions, and fully recognizing that there are numerous interactions among them, consider these:

- Accredited Investors (net worth $1 mm, income, investment amount, *et al.*);
- Qualified Clients (net worth $1.5 mm, $750 thousand investment);
- Qualified Purchasers ("Investments" $5 mm; knowledgeable employee test);
- Qualified Eligible Persons (securities portfolio of at least $2 mm (or a minimum margin requirement); knowledgeable employee test); and
- The Release now adds: "accredited natural person" for 3(c)(1) funds ("Investments" of at least $2.5 million) and this one is to be reset every five (5) years, while other standards are not.

As active practitioners in this area of law and regulation, we readily note and question why it is that:

- The insider notion of Regulation D (officers, directors, executives) differs from the knowledgeable employee definition of Section 3(c)(7) and that of the Qualified Eligible Person;

- The notion of "investments" for purposes of Section 2(a)(51) of the Company Act and that of the "accredited natural persons", as proposed, differ from each other, perhaps not substantially, but they are different.

In adopting National Securities Markets Improvement Act of 1996 ("NSMIA")[25], Congress granted the Commission the authority to define the term "qualified purchaser" under the Securities Act. In response, the Commission proposed defining "qualified purchaser" to mean an accredited investor as defined in Rule 501(a) of Regulation D.[26] In doing so, the Commission noted, among other things, the legislative intent which looks to simplification and eliminating redundancy. We believe the same principals should be applied in adopting any proposed modifications to the definition of accredited investor.

Lastly, we have a significant hedge fund practice, with clients in the U.S., the United Kingdom and much of Europe. We are seeing first hand that our U.S. regulations vis- à-vis hedge funds and investment advisers are causing confusion not only to U.S. but to overseas investment professionals. In our view, this confusion is inhibiting the continued growth and success of our U.S. markets. As a result, more and more financial services activity is moving to London or refraining from involvement in the U.S. market.

IV. New Set of Proposed Rules.

Finally, we respectfully suggest that before any final action is adopted, another round of proposed rules taking into account industry comments to the Proposed Rules is drafted by the Commission staff and is circulated for further consideration. The matter is important enough in our view to warrant such action and care. Such was the approach that the CFTC took prior to

[25] Pub. L. 104-290, 110 Stat. 3416 (Oct. 11, 1996).
[26] *Supra* note 13.

adopting amendments to Rules 4.13 and 4.14 of the Commodity Exchange Act.[27] The adoption of amendments to Rules 4.13 and 4.14 was a two step process whereby the CFTC released proposed amendments based on suggestions from the National Futures Association and the Managed Funds Association that were open for industry commentary.[28] A second round of proposed rules was released based on the futures industry input as to what the amendments should address and the CFTC invited more comments to this second release.[29] Final rules were then issued after receiving further input from the futures industry.[30]

We would be happy to meet with the Commission staff to discuss this further if requested to do so.

Respectfully submitted,

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[27] *See* Additional Registration and Other Regulatory Relief for Commodity Pool Operators and Commodity Trading Advisors; Part Performance Issues; final rules. 68 Fed. Reg. 47221-47237 (August 8, 2003).
[28] *See* Commodity Pool Operators and Commodity Trading Advisors; Exemptions from Requirement to Register for CPOs of Certain pools and CTAs Advising Such Pools; advance notice of proposed rulemaking. 67 Fed. Reg. 68785-68790 (November 13, 2002).
[29] *See* Commodity Pool Operators and Commodity Trading Advisors; proposed rules. 68 Fed. Reg. 12622-12639 (March 17, 2003).
[30] *See* Additional Registration and Other Regulatory Relief for Commodity Pool Operators and Commodity Trading Advisors; Part Performance Issues; final rules. 68 Fed. Reg. 47221-47237 (August 8, 2003).