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March 8, 2007

Ms. Nancy M. Morris
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-1090

Re: *Request for Comment on Proposed Rules under the Securities Act of 1933 and the Investment Advisers Act of 1940 regarding the Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles; Accredited Investors in Certain Private Investment Vehicles; File No. S7-25-06*

Dear Ms. Morris:

We submit this letter in response to the specific requests of the Securities and Exchange Commission (the "Commission") in Release No. IA-2576 (the "Release") for comment on proposed rules 216 and 509 under the Securities Act of 1933, as amended (the "Securities Act"), which would define a new category of accredited investor, and proposed rule 206(4)-8 under the Investment Advisers Act of 1940, as amended (the "Advisers Act"), which would prohibit an adviser to a pooled investment vehicle from making false or misleading statements to any investor or prospective investor in such a vehicle (collectively the "Proposed Rules").[1]

Seward & Kissel LLP has a substantial number of clients who serve as advisers to investment pools which would be investment companies (as defined in Section 3(a) of the Investment Company Act of 1940, as amended (the "Company Act")) but for the exclusions provided by Sections 3(c)(1) and 3(c)(7) of the Company Act.

We appreciate the opportunity to comment on the Proposed Rules and the Release, especially considering the broad implications that the Proposed Rules, if adopted, would have on the business of many of our clients. The views we express in this letter, however, are our own and do not necessarily reflect those of our clients.

We urge the Commission to consider our comments before adopting the Proposed Rules.

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[1] SEC Prohibition of Fraud by Advisers to Certain Pooled Inv. Vehicles; Accredited Investors in Certain Private Inv. Vehicles, 17 C.F.R. pts. 230 and 275 (2006) [hereinafter Release].

I. Proposed Amendments to Private Offering Rules under the Securities Act

A. General

Proposed Rule 509 would require a natural person investing in a Section 3(c)(1) fund to qualify as both (i) an accredited investor under Securities Act Rule 501(a) ("Accredited Investor") and (ii) an accredited natural person under the Proposed Rule ("Accredited Natural Person") in order to qualify as an Accredited Investor. An Accredited Natural Person would mean any natural person who meets either the net worth or income test specified in Securities Act Rules 501(a) or 215, as applicable, and who owns at least $2.5 million in investments, as adjusted for inflation.

While we believe that it may be appropriate to revisit the current Accredited Investor standard, we disagree with the Proposed Rule's complex new regime that targets only Section 3(c)(1) funds.[2] We believe the Commission can better achieve its stated purpose of providing additional investor protection by simply updating the current net worth and income standards under Regulation D. The advantages of this approach are:

- it is simpler and therefore would lead to less confusion among investors and private placement issuers,
- it preserves a meaningful distinction between Section 3(c)(1) funds and Section 3(c)(7) funds, and
- it is more likely to achieve the Commission's objective of raising the bar for investor protection.

In addition, we believe that the Commission has clearer authority to promulgate a change to the definition of Accredited Investor, as opposed to a new definition that effectively amends Section 3(c)(1) of the Company Act.[3]

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[2] We note that recent staff findings are inconsistent with changing the current Accredited Investor standard. In the Implications of the Growth of Hedge Funds, Staff Report to the SEC, the staff submitted a comprehensive report about the recent growth of hedge funds. Available at http://www.sec.gov/spotlight/hedgefunds.htm [hereinafter 2003 Staff Report]. The nine recommendations listed by the staff to improve the operations and practices of investment pools did not include a recommendation to alter the Accredited Investor standard. Despite acknowledging that "inflation, along with sustained growth in wealth and income... has boosted a substantial number of investors past the 'accredited investor' standard," the staff noted that the existing Accredited Investor standard "struck the appropriate balance between investor protection and capital formation needs." Id. at 16, 80. The staff also found that "most hedge funds maintain investment minimums that effectively limit the entry of minimally qualified investors into the funds." Id. at 80. In fact, the staff cited a 2001 proposed release, which stated that the Commission's considerable regulatory experience with the use of the term Accredited Investor led the Commission to conclude that the definition was appropriate as it was, required no change, and provided a "meaningful relief for issuers offering securities, especially small businesses." See Defining the Term "Qualified Purchaser" under the Securities Act of 1933, Release No. 33-8041, 17 C.F.R. pt. 230, at 9 (Dec. 19, 2001). The Commission has not identified any change since the 2003 Staff Report or the 2001 proposed release.

[3] We believe that by imposing an enhanced requirement on natural persons investing in 3(c)(1) funds, the Proposed Rule effectively amends Section 3(c)(1) of the Company Act. We do not believe that the Commission has authority to amend Section 3(c)(1) or adopt rules that have the effect of a legislative change. In 1996, Congress amended the Company Act to add Section 3(c)(7). Notably, Congress did not amend Section 3(c)(1) when it had the opportunity to do so because Congress concluded that investors were adequately protected under Section 3(c)(1). The Proposed

Our concerns with Proposed Rule 509 are described below.

B. *Section 3(c)(1) Funds Should Not be Treated Differently Than Other Private Placement Issuers*

We do not believe that the Commission has set forth a basis for distinguishing Section 3(c)(1) funds from other private placement issuers in proposing the Accredited Natural Person standard. We recommend that if the Proposed Rule is adopted, it should apply to natural persons investing in all types of private placement issuers, rather than singling out natural persons seeking to invest in Section 3(c)(1) funds.

The Commission states that "private pools have become increasingly complex and involve risks not generally associated with many other issuers of securities,"[4] but the Release does not provide any evidence in this regard. First, the private fund industry is varied and contains a large number of pools with varying degrees of risk. For example, some of our clients have established Section 3(c)(1) funds as an administrative convenience to allow smaller investors to access the same non-leveraged long-only strategies offered to large institutional investors on a separate account basis. Second, virtually all Section 3(c)(1) funds deemed to be "hedge funds" invest primarily in liquid securities and offer some form of periodic redemption rights to investors. On the other hand, other types of private placement issuers (e.g., issuers that invest in real estate, windmills, technology, etc.) own only illiquid or intangible assets and typically do not offer any liquidity to their investors. The Commission's position that such investments are "less risky" than Section 3(c)(1) funds appears to be unfounded. If a new accredited investor standard is adopted, we believe that it should apply across the board to all private placement issuers.

C. *The Proposed $2.5 Million in Investments Standard Is Inappropriate*

The Commission solicits comment as to whether its proposed investments standard ($2.5 million in investments, in addition to the current net worth and income standard) would be an appropriate way to measure whether a person has sufficient knowledge and financial sophistication to evaluate the merits of a prospective investment in a private investment vehicle and to bear the economic risk of such an investment.[5] We offer the following comments:

(i) For the reasons stated above, we do not believe that using an investments standard is appropriate or necessary for determining investor sophistication in a Section 3(c)(1) fund or other private placements and believe that the Accredited Investor net worth and income standards, updated as suggested, address the Commission's concerns. The investments standard dramatically raises the bar for investors in Section 3(c)(1) funds by excluding homes and other assets. The investments standard would not be necessary, if the net worth and income standards were to be increased.

Rule can be viewed as circumventing Congressional intent by amending the definition of Accredited Investor under Regulation D only with respect to private offerings by Section 3(c)(1) funds.

[4] Release, at 17.

[5] Id. at 22.

(ii) Adoption of the new investments standard would cause confusion because it borrows from the qualified purchaser standard under Section 2(a)(51)(A) of the Company Act ("Qualified Purchaser"), and yet would be applied and defined differently. The Proposed Rule would provide that the investments of a natural person seeking to make an investment in a private investment vehicle on his or her own behalf may include only 50% of such person's investments held jointly with that person's spouse. However, in determining whether a natural person is a Qualified Purchaser, Rule 2a51-1(g)(2) of the Company Act permits a natural person to include 100% of any investments held jointly with a spouse. If the Commission adopts the Proposed Rule, we believe that it should mirror Rule 2a51-1(g)(2).

(iii) Proposed Rule 509 would treat personal real estate inconsistently, which would lead to further confusion. Under Proposed Rule 509, real estate would count toward the $1 million net worth calculation for determining whether a natural person is an Accredited Investor, but would not count toward the $2.5 million in investments calculation for determining whether a natural person is an Accredited Natural Person. Different instructions within the same rule for treatment of the same asset would undoubtedly lead to confusion.

(iv) The proposed $2.5 million in investments standard would dramatically raise the bar for investors in Section 3(c)(1) funds beyond what an inflation adjustment to the current Accredited Investor net worth standard would require. The study cited by the Commission and conducted by the Office of Economic Analysis ("OEA") estimated that if the Accredited Investor net worth requirement was adjusted for inflation, it would have been $1.9 million net worth as of July 1, 2006. Proposed Rule 509 does not implement OEA's conclusion. This is inconsistent with the Commission's past approach. In 1998, the Commission amended Advisers Act Rule 205-3 by increasing the net worth standard from $1 million to $1.5 million in order to accurately offset the effects of inflation. By not tracking the inflation rate, the $2.5 million figure seems to be both arbitrary and a deviation from prior Commission policy.

D. Failure to Include a Grandfather Provision Unnecessarily Interferes with Existing Client Arrangements

Proposed Rule 509 does not contain a "grandfather" provision. A natural person currently invested in Section 3(c)(1) funds who does not meet the definition of Accredited Natural Person under Proposed Rule 509 would be able to remain invested in Section 3(c)(1) funds, but would not be able to make additional investments. In the Release, the Commission requests comment on whether a grandfather provision permitting such investors to make additional investments is necessary and/or appropriate, and why.[6] If the Commission adopts Proposed Rule 509, we recommend that the Commission add a grandfather provision. We believe that if the Commission fails to include such a provision, the Commission risks unnecessarily interfering with the existing arrangements that Section 3(c)(1) funds have with their clients. We make this recommendation for two reasons.

First, the inclusion of a grandfather provision would be consistent with the Commission's prior rule-making. In the 1998 amendments to Rule 205-3 under the Advisers Act, the Commission increased the net worth and assets-under-management thresholds that a

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[6] Release, supra note 1, at 25.

client must meet for a registered investment adviser to charge a client a performance fee.[7] In doing so the Commission adopted a transition rule permitting a registered investment adviser to charge a performance fee to an existing client who did not meet the enhanced thresholds, as long as such adviser entered into the advisory contract with such client prior to August 20, 1998.[8] The Commission included a similar transition rule in the original adoption of Advisers Act Rule 205-3.[9]

Second, the inclusion of a grandfather provision would be consistent with similar Congressional legislation. In the National Securities Markets Improvement Act of 1996 ("NSMIA"), under which, among other changes, Congress added Section 3(c)(7) to the Investment Company Act, a grandfather provision was included permitting an existing Section 3(c)(1) fund that converted into a Section 3(c)(7) fund to accept additional investments from existing investors (including natural persons) that did not meet the Section 2(a)(51)(A) definition of Qualified Purchaser.[10] According to Hon. Thomas J. Bliley, Jr., Chairman of the House Commerce Committee at the time, "[t]he Grandfather Provision was designed to enable existing Section 3(c)(1) funds to preserve their arrangements with...non-qualified purchasers."[11] We recommend that the Commission similarly choose to permit Section 3(c)(1) funds "to preserve their arrangements" with current investors who do not meet the new Accredited Natural Person standard.

E. Knowledgeable Employees Do Not Require Added Protection

The Commission requests comment on whether employees of Section 3(c)(1) funds or their investment advisers (collectively, "pool employees") should be subject to Proposed Rule 509's Accredited Natural Person standard.[12] The Commission requests comment on whether it should add to the list of Accredited Natural Persons certain "knowledgeable employees," consistent with the concept of "knowledgeable employees" eligible to invest in private investment pools in accordance with Company Act Rule 3c-5.[13]

If the Commission adopts Proposed Rule 509, we recommend that the Commission add "knowledgeable employees" to the definition of Accredited Natural Person, thereby conforming the Proposed Rule with the treatment of "knowledgeable employees" investing in Section 3(c)(7) funds under Company Act Rule 3c-5. We make this recommendation for two reasons.

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7 Exemption to Allow Inv. Advisers to Charge Fees Based Upon a Share of Capital Gains Upon or Capital Appreciation of a Client's Account, Investment Advisers Act Release No. 1731 (July 15, 1998) [hereinafter 1998 Release].

8 See 17 C.F.R. § 275.205-3(c)(1).

9 This transition rule permitted advisers not registered or required to be registered under the Advisers Act to continue to charge a performance fee to clients who did not meet the net worth and assets-under-management thresholds as adopted in 1985, as long as the advisory contract was entered into prior to November 14, 1985. See Exemption to Allow Registered Inv. Advisers to Charge Fees Based Upon a Share of Capital Gains Upon or Capital Appreciation of a Client's Account, Investment Advisers Act Release No. 996 (November 26, 1985), at 21-22.

10 See 15 U.S.C. § 80a-3(c)(7)(B).

11 142 CONG. REC. at E1929 (daily ed. Oct. 4, 1996) (statement of Hon. Thomas J. Blilely, Jr.).

12 Release, supra note 1, at 26.

13 See 17 C.F.R. § 270.3c-5.

First, we do not believe that "knowledgeable employees" require the protection that the Commission would provide them if it does not include "knowledgeable employees" in the definition of Accredited Natural Person. "Knowledgeable employees," as defined in Company Act Rule 3c-5, include (i) executive officers, directors, trustees, general partners and advisory board members of funds and (ii) employees and affiliated persons of funds "who, in connection with his or her regular functions or duties, participates in the investment activities of such" funds.[14] The Commission stated in a 1999 No-Action Letter that "[Company Act] Rule 3c-5 is premised on the belief that certain persons [i.e., knowledgeable employees], because of their financial knowledge and sophistication and their relationship with the...Fund, do not need the protection of the Investment Company Act."[15] We recommend that the Commission not impose an additional measure of investor protection on persons presumed to have sufficient access to information and financial sophistication.

Second, we do not understand why the Commission would be less restrictive with fund employees in the context of Section 3(c)(7) funds than in the context of Section 3(c)(1) funds. If the Commission does not include "knowledgeable employees" in the definition of Accredited Natural Person, a natural person who meets the definition of "knowledgeable employee" under Company Act Rule 3c-5 but is not an Accredited Natural Person would be able to invest in a Section 3(c)(7) fund but not in a Section 3(c)(1) fund (other than as a non-accredited investor).[16] Yet to invest in a Section 3(c)(7) fund a natural person must be a Qualified Purchaser, which is a higher eligibility standard than the Accredited Natural Person standard applicable to Section 3(c)(1) funds under Proposed Rule 509.

F. Inadvertent Consequences of the Proposed Rule

(i) The Commission proposes to adjust the $2.5 million dollar amount for inflation on April 1, 2012, and every five years thereafter, to reflect any changes in the value of the Personal Consumption Expenditures Chain-Type Price Index.[17] We believe such adjustments could have the unintended result of ultimately raising the Accredited Natural Person standard higher than the Qualified Purchaser standard.

(ii) We are concerned that Proposed Rule 509 would significantly increase barriers to entry for early stage investment advisers by reducing the pool of investors qualified to invest in such advisers' new Section 3(c)(1) funds. Such heightened barriers to entry risk discouraging talented portfolio managers from starting their own investment pools, thereby dampening the entrepreneurial spirit that has historically defined the private fund industry.

II. Proposed Rule 206(4)-8 under the Advisers Act Is Unnecessary and Risks Hampering Candid Communication with Clients

Proposed Rule 206(4)-8 would prohibit investment advisers to Section 3(c)(1) and Section 3(c)(7) funds, whether required or not required to be registered under the Advisers Act,

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[14] 17 C.F.R. § 270.3c-5(a)(4).

[15] A.B.A. Section of Bus. Law, SEC No-Action Letter, at 15 (April 22, 1999).

[16] See 17 C.F.R. § 270.506(b)(2)(i).

[17] Release, supra note 1, at 23.

from making material misstatements and omissions to investors and prospective investors in such funds, as well as engaging in any fraudulent conduct with respect to such investors and prospective investors.[18]

While we recognize there is a fundamental need to prevent fraud in the hedge fund industry, and we appreciate the Commission's objective in proposing Proposed Rule 206(4)-8, we believe that the Proposed Rule is unnecessary. According to the Commission, Goldstein v. Securities and Exchange Commission[19] ("Goldstein") "created some uncertainty" as to whether Sections 206(1) and 206(2) of the Advisers Act apply to the defrauding of investors in investment pools because Goldstein construed the term "client" to mean the pool itself and not the investor in the pool.[20] Proposed Rule 206(4)-8 is intended to resolve this uncertainty by explicitly prohibiting the defrauding of investors and prospective investors in Section 3(c)(1) and Section 3(c)(7) funds by the investment advisers to such funds. However, Section 206(4) of the Advisers Act already provides, "It shall be unlawful for any investment adviser, by use of the mails or any means or instrumentality of interstate commerce, directly or indirectly—(4) To engage in any act, practice or course of business which is fraudulent, deceptive, or manipulative."[21] Section 206(4) does not use the term "client." In light of the broad scope of Section 206(4) of the Advisers Act, it appears that Proposed Rule 206(4)-8 is unnecessary.

If the Commission intends for Proposed Rule 206(4)-8 to resolve the uncertainty created by Goldstein, we recommend that the Commission consider adopting only provision (a)(2) of the Proposed Rule. This provision appears to sufficiently clarify that Section 206(4) of the Advisers Act prohibits the defrauding of investors and prospective investors by advisers to Section 3(c)(1) and 3(c)(7) funds. The inclusion of provision (a)(1) in Proposed Rule 206(4)-8 seems to go further than is necessary to achieve the Commission's stated objective.

Furthermore, we are concerned that, as an unintended consequence, provision (a)(1) of Proposed Rule 206(4)-8 would substantially expand the Commission's enforcement power over advisers with respect to routine communications and day-to-day activities of private funds. Proposed Rule 206(4)-8(a)(1) incorporates language from Rule 10b-5 under the Securities Exchange Act of 1934, as amended, but would apply regardless of whether the pool is offering, selling or redeeming a security. In addition, the Commission has specifically stated that under the Proposed Rule it would not need to demonstrate that an adviser acted with scienter. Under the Proposed Rule, the Commission would theoretically be able to take enforcement action against an adviser who, for example, made an unintended typographical error in a routine email to an investor. As a result, we are concerned that Proposed Rule 206(4)-8 may have the unfortunate effect of hampering frequent and candid communication between advisers and their investors.

In addition, we are not certain why Proposed Rule 206(4)-8 singles out Section 3(c)(1) and Section 3(c)(7) funds. According to the 2003 Staff Report to the United States Securities and Exchange Commission (the "2003 Staff Report"), "[t]here is no evidence indicating that hedge funds or their advisers engage disproportionately in fraudulent activity."[22]

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[18] Id. at 66-67.

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

[20] Release, supra note 1, at 6.

[21] 15 U.S.C. § 80b-6(4).

[22] 2003 Staff Report, supra note 2, at 73.

Since then, the Commission has not offered any empirical data to support such an anti-fraud regulation for advisers to Section 3(c)(1) and Section 3(c)(7) funds. If the Commission is going to adopt an anti-fraud rule directed at pooled investment vehicles, we recommend that the rule be broadly applied.

While we appreciate that the Commission is trying to clarify the scope of the anti-fraud provisions of the Advisers Act in light of Goldstein, we believe that the proposed anti-fraud rule is unnecessary. If the Commission adopts Proposed Rule 206(4)-8, we recommend that it only adopt provision (a)(2), but apply provision (a)(2) to all pooled investment vehicles, not just Section 3(c)(1) and 3(c)(7) funds.

III. Cost Benefit Analysis

The Commission requests comment on the costs and benefits of the Proposed Rules.[23]

A. Proposed Rules 509 and 216

The Commission requests comment on the nature and extent of the costs to private pools and investors that would result from the proposed addition of the Accredited Natural Person standard.[24] There is a considerable opportunity cost for those investors no longer able to make investments in Section 3(c)(1) funds. In addition, advisers to Section 3(c)(1) funds would suffer lost revenue and incur substantial costs in updating fund documentation.

B. Proposed Rule 206(4)-8

Although the Commission "recognize[s] that there are costs involved in assuring that communications to investors and prospective investors do not contain untrue or misleading statements,"[25] the Commission may not be aware of the significant costs that advisers to Section 3(c)(1) and Section 3(c)(7) funds would incur as a result of Proposed Rule 206(4)-8. Because advisers and their principals and chief compliance officers could face significant liability and potential Commission enforcement action as a result of routine communications with clients, advisers would need to conduct extensive reviews of all communications, resulting in unquantifiable expense.

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[23] Release, supra note 1, at 45.
[24] Id. at 45.
[25] Id. at 39.

We appreciate the opportunity to comment on the Proposed Rules. If you have any questions regarding this letter, please contact the undersigned at the telephone numbers indicated below.

Very truly yours,

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and

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