Alternative Investment Management Association

The Forum for Hedge Funds, Managed Futures and Managed Currencies

Ms. Nancy M. Morris,
Secretary,
Securities & Exchanges Commission,
100 F Street, NE,
Washington,
DC 20549-1090,
USA

9th March 2007

(by mail in triplicate and by email to rule-comments@sec.gov)

Dear Madam,

<u>File No. S7-25-06 - AIMA's comments on proposed new rule 206(4)-8 under the Investment Advisers Act of 1940 and new rules 216 & 509 under the Securities Act of 1933 -</u>

We are submitting our comments on the Commission's proposals for new rules regarding anti-fraud provisions and the 'accredited investor' criteria.

The Alternative Investment Management Association Limited ("AIMA") is – some 16 years after its establishment - the only professional trade association representing the hedge fund industry with worldwide membership. It is also the only such association which represents all practitioners in the alternative investment management industry – whether hedge fund managers, managers of futures or currency funds or those providing other specific services such as prime brokerage, administration, legal or accounting, auditing and tax advisory services.

In addition, AIMA works closely with national securities' regulators, other interested regulatory and fiscal bodies and investors; those interests receive all our educational and research materials and services without charge.

AIMA is a not-for-profit educational and research body. Its membership is corporate and now comprises over 1,100 firms in 47 different countries. AIMA's growth has been commensurate with the development of the hedge fund industry worldwide.

The three 'pillars' of AIMA are:

- Education;
- Regulation; and
- Sound practices.

AIMA's objectives specifically include increasing investor education and the use and application of transparency, sound practices and due diligence in the industry, in the promotion of the responsible use of alternative investments.

The Commission has proposed rules (published on 2nd January) intended to create:

- a new anti-fraud rule for all investment advisers; and
- a new investor category of 'accredited natural person'.

The proposals are not entirely unexpected and, of course, AIMA welcomes any reasonable initiative which seeks to reduce the likelihood of investors falling victim to fraud. However, the proposals do raise some concerns both as to the scope of the proposed rules and as to the 'extra-territorial reach' of the Commission in respect of firms not registered with it but established and regulated outside the US.

In responding to the Commission's proposals, we have also taken account of the Principles and Guidelines on Private Pools of Capital (Hedge Funds) issued on 22nd February 2007 by the President's Working Group (PWG). Those broad principles are "designed to endure as financial markets continue to evolve" and to "provide a clear but flexible principles-based approach to address the issues presented by the growth and dynamism of these investment vehicles."

We note that, summarizing the PWG's report very briefly, the PWG focuses on strengthening investor protection and guarding against systemic risk and considers that the best measures to be taken by regulators and supervisors are to:

- work together to enforce their expectations as to counterparty risk management practices;
- refine and augment their policies continually, to reflect market developments; and
- use anti-fraud and anti-manipulation authority, to preserve and enhance the integrity of capital markets.

Those suggestions are instead of, for example, recommending introduction of substantive regulation and leverage limits.

The Commission's Proposed Rules

The following paragraphs deal briefly with the main points of each new rule.

A) Anti-fraud provisions

The new anti-fraud rule (under Section 206(4)-8 of the Investment Advisers Act of 1940) would apply to all advisers, whether registered with the Commission or not, and make it an offence to:

- make any untrue statement of a material fact or to omit to state a material fact necessary to make the statements made, in the light of the circumstances under which they were made, not misleading, to any investor or prospective investor in the pooled investment vehicle; or

- otherwise engage in any act, practice or course of business that is fraudulent, deceptive or manipulative with respect to any investor or prospective investor in the pooled investment vehicle.

This rule, if adopted, would cover 'pooled investment vehicles' – including funds exempt under Sections 3 (c)(1) and 3 (c)(7) of the Investment Company Act of 1940, hedge funds, private equity and venture capital funds. The rule would also cover all activities and communications, not solely those in respect of the sale or purchase of securities and regardless of whether a manager is registered with the Commission. The rule would apply to private placement memoranda, offering circulars and responses to 'requests for proposals'.

Breach of the rule would not give rise to a private right of action under this rule, so that an investor could not sue a manager, but the Commission would enforce through administrative and civil action against the manager. To make use of this rule when bringing enforcement proceedings against a manager, the Commission would have to show that the manager acted negligently, rather than intentionally – i.e. there would be no requirement to show that the manager deliberately or knowingly violated the rule.

B) Accredited natural person criteria

The proposed new rules (under Sections 216 and 509 of the Securities Act of 1933) are said to be concerned with issues affecting consumer protection.

They would apply to funds which are exempt under Section 3 (c)(1) of the Investment Company Act 1940 – so that, if an investor does not qualify as an accredited natural person when the rules become effective, a manager will be in breach.

No 'grandfathering' provisions are included in the proposal - a manager will, therefore, need to ensure (or reconfirm) that each investor in such a fund is, as and when the rules come into effect, in compliance.

The Commission proposes to exclude funds using the Section 3(c)(7) exemption because investors in those funds – who are 'qualified purchasers' - are also accredited investors and, as such, they are regarded as financially sophisticated and able to decide for themselves upon matters such as governance provisions, investment risk and leverage.

The proposed new threshold would not apply to directors, executive officers or general partners but would apply to 'knowledgeable employees'. The rules would not prevent up to 35 non-accredited investors continuing to participate in a fund under Rule 506 and would not apply to some venture capital funds which invest in US private companies.

As far as a non-US manager is concerned, the rules would affect him if he is marketing a Section 3 (c)(1) fund in the US; he would need to revise the offering and subscription documents and ensure that US investors are in compliance with the new threshold requirements.

The test for an accredited natural person would require an individual to have:

- own net worth (or jointly with a spouse) of greater than $1 million; or
- own income of over $200,000 (or jointly with a spouse, over $3,000,000) in each of the two most recent years; and
- alone, or jointly with a spouse, not less than $2,500,000 (adjusted every 5 years for inflation) in investments issued by a 'private investment vehicle' under Regulation D or s.4(6) of the Securities Act of 1933.

In the case of a non-US fund investing in commodity futures or futures options on US markets, the proposals may give rise to other considerations, which may cause more concern. A manager of such a fund must register as a commodity pool operator (CPO) or a commodity trading advisor (CTA) with the Commodity Futures Trading Commission CFTC. There are CFTC exemptions from CPO registration available to non-US entities:

- Rule 4.13(a)(3) is an exemption for CPOs with sophisticated investors; and
- Rule 4.13(a)(4) is an exemption for qualified purchasers.

A non-US fund with an accredited natural person as an investor would not be able to bring itself within the CFTC Rule 4.13(a)(4) exemption. Given the choice of marketing to an individual with
more investments and the ability to avoid restrictions on trading commodity futures or futures options on US markets, the monetary difference between the two tests would indicate that a Section 3(c)(7) fund might be preferable.

The Commission estimates that the proposed rule would eliminate approximately 80% of current potential 'accredited investors' and considers that reducing the investor pool will increase competition and lower fees. While there were perhaps 200 hedge funds in 1982, today the number may be nearer 10,000; that increase greatly exceeds the increase in numbers of accredited investors and there is no evidence that such increased competition for investors has lowered fees.

General points

C) Anti-fraud provisions

1. The proposed rule appears broadly similar to UK legislation and regulations as to misleading statements, practices etc. However, there may be reason to query whether a manager would be liable if his statement/omission etc were misleading, even without there being any dishonest concealment or recklessness on his part.

2. Disclosure to investors concerning 'side letters' is specifically covered in the proposals. It appears that the Commission might, as the rule is proposed, be capable of exercising an unreasonable amount of power and oversight in this area. AIMA recently issued Industry Guidance on this subject for UK-regulated hedge fund managers, having worked very closely with the FSA in the UK; the FSA reviewed that guidance and has confirmed that it will take it into account when exercising its regulatory functions. We suggest that the Commission might consider and use that guidance (which is available to members and non-members alike, as the FSA requested, via AIMA's home page – at www.aima.org – and a copy is sent with this letter).

   Such an important subject as side letters is, we suggest, far better addressed in an international context – an approach which AIMA has always encouraged.

3. It is not clear from the proposed rule whether a manager regulated by, for example, the FSA in the UK or the SFC in Hong Kong who is not registered with the Commission and who communicates with a non-US investor would be subject to the rules. We see no reason why the Commission should consider it might have jurisdiction over such a manager in such circumstances and we would request clarification on this.

4. The evolution of the industry (including recent Initial Public Offerings in the US and elsewhere) and the increased influence of institutional investors may well have more impact on fostering transparency and best practices than regulations.

D) Accredited natural person criteria

1. Perhaps the threshold should, instead of a minimum monetary investment limit (which must be adjusted from time to time, to reflect inflation, for example), be a percentage of an individual's overall investable (or, disposable) assets; a pensioner investor may well have $2.5 million in disposable assets but he may not be an investor for whom a hedge fund might be appropriate. We note that one comment letter posted on the Commission's site suggests that 20% might be a proper proportion.

2. The original intention of the accredited investor definition was to 'carve out' an exemption for those investors deemed sophisticated. While the definition might usefully be revised, to bring it in line with current economics as proposed, we do not consider that an effective means of regulating access to alternative investments.

3. We query whether the rule should apply to funds registered under the Investment Company Act; there are a growing number of funds, such as hedge fund of funds and private equity vehicles, which are now registering as investment companies.

4. We query why venture capital funds – which, arguably, are less liquid and of a higher risk profile - should be regarded as more accessible. The Commission's Staff was reported (at the open meeting when the proposals were approved by the Commissioners) to view such funds as playing a critical role in initial capitalization of small business in the US but, in our submission, that of itself does not mean that they are a more appropriate vehicle for an investor.

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5. From the perspective of a non-US hedge fund manager, since most hedge funds (certainly more recently) are Section 3(c)(7) 'qualified purchaser' funds, rather than Section 3(c)(1) 'accredited investor' funds, the proposed change in eligibility criteria may not, in fact, have a very significant impact. However, non-US funds and managers may well be even less inclined to establish and manage funds for US investors, as a result of increased regulation in the US. One consequence, therefore, would be that competition will be reduced and US investors' choice of investment opportunities narrowed.

6. We note that the rules are not intended to be retrospective, so that an existing investor who does not meet the new eligibility criteria may remain invested in a fund (although he will not be able to make any further subscriptions). We presume, therefore, that only individual investors who apply for further shares need be 'tested' (or must warrant their eligibility) to ensure that they meet the new standard.

Generally

Hedge fund managers outside the US are usually fully regulated by their own national authority and the UK's FSA, for example, already has rules in respect of the areas which the Commission's proposals cover. We consider that the Commission should be able to place reliance on the FSA (and other national regulators) and, if there were to be any matters on which the Commission believes that the FSA's rules are not sufficient, dialogue between the two authorities would seem the preferred, sensible and practical means of addressing any concerns. As we have argued before, we do not agree that the Commission should seek to exercise 'global reach' or impose its own rules on those based in or operating in other jurisdictions which have proper and sufficient regulatory reach, oversight and control.

The increasing regulatory 'reach' of the Commission as regards hedge fund managers has already acted as a deterrent to those based outside the US and who have contemplated offering - or have previously offered - fund interests to US investors. We note that 2,161 hedge fund managers – including 208 UK managers - registered with the Commission under its earlier registration requirement; since the decision in *Goldstein v. SEC,* 355 in total have withdrawn their registration - including 75 UK managers - and 75 managers in total have registered since that decision. In the case of the UK managers, they have always been and remain fully and properly regulated by the FSA.

The revised eligibility proposals will add further concern to such managers - who are already subject to sufficient and efficient regulation and oversight in the place(s) in which they are based and / or operate.

As a final point, we mention that the differences in definitions as to criteria governing investor eligibility among various US statutory or regulatory provisions relating to securities gives rise to considerable confusion for investors and managers, which is not helpful to the industry; we would be pleased if improvements in the form of more standardised definitions could be introduced.

Yours faithfully,

Mary Richardson
Director - Regulatory Department

AIMA's Industry Guidance Note on Side Letters

Introduction and status

AIMA has had several constructive meetings with the FSA seeking clarification of various issues arising out of Feedback Statement 06/2 (FS06/2) regarding the use and disclosure of side letters and is now issuing this Industry Guidance.

Since the publication of FS06/2, the FSA has clarified its approach to the use and disclosure of side letters.

The decision whether to follow this Industry Guidance is for the firms concerned. However, the FSA has reviewed it and confirmed that it will take it into account when exercising its regulatory functions, although this cannot affect the rights of third parties.

This is not FSA Guidance and, in the event of any conflict, the FSA Handbook prevails.

Disclosure requirement

In summary, firms will be required to disclose the existence of side letters which contain "material terms", and the nature of such terms, where the firm is a party to the side letters or is aware that a fund of which the firm or an affiliated entity is the investment manager is a party to them. Firms will not be required to disclose the existence of side letters which contain no material terms.

What is a material term?

A material term can be defined as:

> "Any term the effect of which might reasonably be expected to be to provide an investor with more favourable treatment than other holders of the same class of share or interest which enhances that investor's ability either (i) to redeem shares or interests of that class or (ii) to make a determination as to whether to redeem shares or interests of that class, and which in either case might, therefore,

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reasonably be expected to put other holders of shares or interests of that class who are in the same position at a material disadvantage in connection with the exercise of their redemption rights".

Common examples of terms which are likely to be regarded as material terms would include preferential redemption rights (including an agreement to accept a shorter notice period for redemptions), 'key man' provisions, redemption 'gate' waivers and portfolio transparency rights. Common examples of non-material terms would include fee rebates and 'most favoured nation' clauses.

A term which would otherwise be a material term may not, however, be a material term if it does not, in practice, provide one investor with more favourable treatment. For example, where a side letter contains a term granting a shorter notice period for redemptions, but the fund undertakes to accept an identical notice period in respect of all other investors in the same share class, the term would be "cured" of its materiality.

Nature of disclosure

Firms should give a brief description of material terms contained in side letters which have been entered into (for example: "we have entered into side letters with investors, which contain material terms which: (a) grant preferential redemption rights; (b) contain a "key man" provision; (c) [etc]").

Firms are not expected to disclose the number of side letters, the dates on which they were entered into or the parties to them.

Where side letters containing material terms have been entered into with investors whose shareholding or interest, individually or in aggregate, is significant (i. e., in excess of 10%), firms should consider highlighting this fact.

Timing of disclosure

Initially, firms will be expected to make disclosure by 31st October 2006 of all material terms contained in side letters entered into prior to that date. Such disclosure should extend to all side letters containing material terms, whether entered into before or after the publication of FS06/2, other than side letters entered into with investors who have previously redeemed their shares or interests.

Thereafter, firms will be expected to keep this disclosure reasonably up-to-date and to make reasonably timely disclosure where a side letter is entered into which contains a material term of a category not included in the firm's previous disclosures.

To whom must disclosure be made?

Firms should make disclosure of relevant side letters both to existing and to prospective investors.

In the case of existing investors, in particular, firms will need to consider to whom it is appropriate to make the disclosure (for example, the registered holder or, where relevant, the holder's authorised representative such as its investment manager).

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Method of disclosure

Firms are at liberty to select the method by which they make disclosure. It is anticipated that many firms will choose to do so in their monthly, quarterly or half-yearly investor reports/newsletters.

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Supplement No.1 to

AIMA's Industry Guidance Note on Side Letters

Introduction and status

Since the publication of AIMA's Industry Guidance on 27 September 2006 members of AIMA and others have raised certain issues relating to the interpretation of the side letter disclosure requirement. AIMA has discussed these issues with the FSA and is now publishing this Supplement to the Industry Guidance.

The decision whether to follow this Supplement to the Industry Guidance is for the firms concerned.

This is not FSA Guidance.

Disclosure requirement

The requirement to disclose the existence of side letters which contain material terms and the nature of those terms (the "disclosure requirement") applies only to a firm which is both (1) an FSA regulated discretionary investment manager which employs hedge fund techniques and (2) an authoritative source of information for fund investors on the investment strategy, risk profile and related matters affecting the relevant fund ("an authoritative source of information"). A discretionary investment manager will be regarded as an authoritative source of information if it is primarily responsible for generating the substance of such information.

The disclosure requirement applies to discretionary investment managers whether they publish such information directly to fund investors or indirectly through the provision of such information to a third party, such as a fund administrator, which then publishes the information.

The disclosure requirement does not apply (a) to firms which only (1) market shares or interests in a fund and/or (2) execute trades for the account of a fund and/or (3) give investment advice in relation to the investment of a fund's assets but which (4) do not exercise any discretionary investment management authority over the fund's assets nor (b) to firms which are fund of hedge fund managers.

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The disclosure requirement does not apply to a firm which is a party to a side letter, but is not itself an authoritative source of information, in circumstances where an affiliated investment manager is an authoritative source of information (for example, this would cover the situation where a US or other non-UK affiliate of the firm is the authoritative source of information).

Grey areas

There remain a number of "grey areas" in relation to the application of the disclosure requirement in certain situations. These situations include (1) where a firm (a) is not a party to certain side letters but is aware that a fund of which an affiliated entity is the investment manager is a party to them, (b) is an authoritative source of information but (c) has no or limited contact with investors and prospective investors because all or most of such contact is the responsibility of a non-UK affiliated manager (such as a US affiliated manager) and (2) where a firm has responsibility for generating only part of such information in conjunction with a non-UK affiliated manager which also generates part thereof.

AIMA intends to continue its dialogue with the FSA in relation to these grey areas and expects to publish further supplements to its Industry Guidance when the position is clearer. The FSA has indicated to AIMA that until then it will not insist on compliance with the disclosure requirement in relation to such areas. However, firms which are in any doubt as to the need for compliance are recommended to seek appropriate professional advice.

Timing of disclosure

The FSA has confirmed to AIMA that it will consider that compliance with the initial disclosure requirement by 31 October 2006 will be satisfied where firms make such disclosure in their investor reports/newsletters which are sent out in early November 2006.

3 November 2006

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