



Setting the global standard for investment professionals

9 March 2007

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

**Re: 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:

The CFA Institute Centre for Financial Market Integrity (Centre)<sup>1</sup> appreciates the opportunity to comment on the proposed rules in this release that intend to provide additional protection to investors in pooled investment vehicles, including hedge funds, by augmenting the current rules pertaining to adviser fraud and revising the accredited investor requirements.

The CFA Centre develops, promulgates, and maintains the highest ethical standards for the investment community, including the CFA Institute *Code of Ethics* and *Standards of Professional Conduct*. The CFA Centre represents the views of investment professionals to standard setters, regulatory authorities, and legislative bodies worldwide to promote investor protection and efficient global capital markets.

**General Comments**

We support efforts, through the proposed rulemakings, to clarify and strengthen existing safeguards for investors in the areas of investment adviser fraud and in terms of meeting certain standards in order to invest in less-regulated financial products. In general, we think that the proposed rules achieve a reasonable balance of providing important benefits to investors at an acceptable cost to the industry.

---

<sup>1</sup> The CFA Centre for Financial Market Integrity is part of CFA Institute. With headquarters in Charlottesville, VA and regional offices in New York, Hong Kong and London, CFA Institute, formerly the Association for Investment Management and Research®, is a global, non-profit professional association of more than 88,900 financial analysts, portfolio managers, and other investment professionals in more than 130 countries of which more than 76,800 are holders of the Chartered Financial Analyst® (CFA®) designation. The CFA Institute membership also includes 134 Member Societies and Chapters in 55 countries and territories.



Comments on specific portions of the proposals follow.

## **I. Investment Adviser Act Revisions**

### ***Proposed Rule 206 (4)-8***

We believe that it is appropriate for the SEC to clarify and augment the application of its adviser rules under the authority conferred through Section 206(4). While it has limited its investment adviser fraud rules under 206(1)-(7) to SEC-registered advisers (in consideration of the allocation of responsibilities resulting from the National Securities Markets Improvements Act), there is no requirement that it must do so. We support additional measures by the SEC to stem adviser fraud, as the incidence of wrongdoing—not the location of the fraud or the size of the perpetrator—ultimately affects all market integrity. We therefore support this rulemaking to deter fraud by all advisers to pooled investment funds by clarifying the scope of the fraud rules.

As proposed, Rule 206(4)-8 would prohibit fraud by investment advisers to pooled investment funds through the making of misleading statements, the omission of necessary facts or through other actions not involving actual statements or omissions. Unlike Rule 10b-5, Rule 206(4)-8 would not require that the fraud occur in connection with a securities transaction or require scienter.

Perhaps most noteworthy is that the rule’s prohibitions would extend to all advisers, whether or not they are registered or required to be registered. This would apply to advisers to all pooled investment vehicles, not just those defined as investment companies, thereby bringing into the fold advisers to hedge funds, private equity funds, venture capital funds, and “other types of privately offered pools that invest in securities, as well as investment companies that are offered to the public.”

### ***Definition of investors***

We believe that all investors should be afforded sufficient protections from fraudulent acts, whether they already invest in the markets or are planning to invest. All individuals in the U.S. financial markets deserve the assurance that our markets are fair. Thus, we support the reach of the proposed rule that extends the prohibitions on fraud to prospective, as well as existing, investors. Anything short of this draws an arbitrary line around the timing of when bad behavior associated with the markets is acceptable, and undermines the integrity that investors deserve to expect.

### ***Misleading statements or other acts***

We appreciate that the SEC staff has decided to cast a broad net in defining what can constitute false and misleading statements for purposes of Rule 206(4)-8. Extending the reach of the rule to a number of areas, including statements regarding planned investment strategies, experiences and credentials of the adviser and associated persons, risks involved, performance of that pool or other funds advised by the same adviser, valuation issues, and practices used by the adviser in his business puts advisers on notice of the degree of care that must be exercised in communications with the investing public.

We also support the approach that does not condition a finding of fraud on affirmative statements, but includes the omission of material facts that are needed to make a communication true. Both forms have the same effect of misleading investors.



Finally, we agree with the approach taken in the proposal that allows a finding of false or misleading statements in instances where there is no purchase or sale of securities, and does not even have to involve a statement. Advisers must be discouraged from any activity that seeks to defraud or has the reasonable effect of defrauding investors. It is important to send a message to advisers and investors alike that fraud of any type will not be tolerated in our capital markets.

#### *Status of advisers*

We recognize that the degree and level of protections that are necessary may vary, depending on the type of investment vehicles involved. As recognized by the SEC and the investing public, hedge funds, in particular, present risks and opportunities not found in other types of investments that warrant appropriate consideration.

Thus, as a general premise, we strongly support efforts to clarify rules applicable to managers of hedge funds and other pooled investment vehicles under a regulatory scheme of Rule 206. Applying aspects of the rule to unregistered as well as registered advisers should help raise standards across the board. Moreover, it helps to restore a more “level playing field” among financial services providers in terms of the ethical behavior owed by all advisers to investors.

## **II. Securities Act Revisions**

### ***Proposed Rules 216 and 509***

In an effort to reduce the risk of investing in private offerings by those investors who may lack the appropriate understanding and risk tolerance, this release proposes a new process for defining “accredited natural person” for purposes of offers and sales by certain 3(c)(1) pools. This process would replace the current approach that is based on a determination of net worth and income alone by requiring the potential investor to also hold at least \$2.5 million in investments, in addition to meeting a net worth or income standard.

It is difficult, and sometimes misleading, to equate financial worth of an individual with investment sophistication. This is particularly so when financial worth may stem from sources unrelated to investments in financial products or simply reflects increases in other holdings (*e.g.*, appreciation in home equity). A certain net worth level cannot presuppose financial sophistication on the part of the individual. Having recognized this, we appreciate the difficulty of designing a test that can measure investment sophistication and the ability to evaluate and assume the risk of investing in less-regulated vehicles.

We agree that use of the current net worth/income test alone is insufficient. Given the limitations of a net worth or income test, we support use of the additional proposed “investments test” for determining accredited investor status. This additional criterion will at least indicate that an individual has substantial experience with (and presumably knowledge of) the investment process.

We also strongly support the proposed approach to exclude the amounts under this test that are attributable to appreciation in property values or other areas that do not necessarily correlate with investment acumen. We believe this approach will help reduce the pool of individuals that qualify financially but lack the degree of experience and understanding that investing in riskier vehicles warrants.



We generally support the dollar limits that are proposed for both the net worth or income tests and the amount of investments test as reasonable. This approach appears to align the percentage of qualifying households with the limits originally intended when Regulation D was adopted. However, the Commission should consider two variations on this approach. First, investors in fund of fund vehicles might warrant retention of the current lower standard on net worth thresholds given that the fund of fund industry serves generally as a turn key expert in selecting and monitoring the underlying hedge fund investments. We would also support grandfathering investors who meet current standards for the funds in which they currently invest, for purposes of future investing in that fund.

### **Conclusion**

We support the attempt through this rulemaking to address the additional risks that investors may face through investments in certain vehicles, such as hedge funds. We believe that the proposed rules, with our suggested modifications take a positive step in providing additional safeguards, while allowing appropriate access for the investing public.

If we can provide additional information, please do not hesitate to contact Kurt Schacht at 212.756.7728 ([kurt.schacht@cfainstitute.org](mailto:kurt.schacht@cfainstitute.org)) or Linda Rittenhouse at 434.951.5333 ([linda.rittenhouse@cfainstitute.org](mailto:linda.rittenhouse@cfainstitute.org)).

Sincerely,

*/s/ Kurt N. Schacht*

Managing Director  
CFA Centre for Financial Market Integrity

*/s/ Linda L. Rittenhouse*

Senior Policy Analyst  
CFA Centre for Financial Market Integrity