March 9, 2007

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

Re: File No. S7-25-06; Rel. Nos. 33-8766, IA-2576
Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles;
Accredited Investors in Certain Pooled Investment Vehicles

Dear Ms. Morris:

The Coalition of Private Investment Companies ("CPIC") is pleased to submit its comments regarding the rule changes proposed by the Securities and Exchange Commission ("SEC" or "Commission") in the above-referenced release (the "Release").[1] CPIC is a membership organization of 19 private investment companies and other associate members, with more than $60 billion under management. Our members are diverse in size and in the investment strategies they pursue.[2] On behalf of our members, we thank the Commission for this opportunity to provide our views on the proposals, and we hope our comments are helpful to you.

The Release describes two proposed changes to the Commission's rules. The first proposal, if adopted, would constitute a new Rule 206(4)-8 under the Investment Advisers Act of 1940[3] ("Advisers Act") to prohibit investment advisers, whether or not they are required to be registered, from making false or misleading statements to, or otherwise defrauding, investors or prospective investors in pooled investment vehicles.[4] The Release explains that the new rule is intended to clarify the Commission's authority under the Advisers Act to protect investors and potential investors in pooled investment

[1] 72 Fed. Reg. 400 (Jan. 4, 2007).

[2] For example, while most of our members are multi-strategy funds that trade a range of financial products, some are long-short equity funds, some pursue strategies that are event-driven, and several are fundamental short funds.

[3] 15 U.S.C. § 80b-20, *et. seq.*

[4] 72 Fed. Reg. at 400.

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vehicles against fraud, in light of any potential ambiguity caused by the decision of the United States Court of Appeals for the District of Columbia Circuit in *Goldstein v. SEC*,[5] which held that, for purposes of section 203(b)(3) of the Advisers Act,[6] the "client" of an investment adviser managing a pooled investment vehicle could only be such a pool, and not the investors therein.

The second proposal, proposed Rules 509 and 216, if adopted, would revise the definition of "accredited investor" in Regulation D[7] as applied to natural persons by creating a new named category of investor, the "accredited natural person," but only for purposes of private offerings of investments in pooled investment vehicles, excluding business development companies.[8] The Release explains that inflation and an increase in real estate values has expanded the number of individuals who qualify as "accredited investors" under existing rules, and it therefore is necessary to establish additional criteria to assure that investors in privately-placed pooled investment vehicles have appropriate financial means and sophistication.[9]

CPIC supports the Commission's proposal to modernize the standards for determining who is an "accredited investor" with the requisite level of sophistication to invest in a private offering under Regulation D. However, in this proposal the Commission has focused on the accredited investor standards for some, but not all, "pooled investment vehicles" and for some, but not all, exempt offerings. Going forward, the Commission may wish to consider whether it has evaluated sufficient data

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5 451 F.3d 873 (D.C. Cir. 2006).

6 Section 203(b)(3) provides, in relevant part, that an investment adviser with fewer than fifteen clients in the preceding year is not required to be registered with the Commission. 15 U.S.C. § 80b-3(b)(3).

7 17 C.F.R. §§ 230.501 to 230.508.

8 72 Fed. Reg. at 403-408. Business development companies are investment companies that Congress established in the Small Business Investment Incentive Act of 1980 in order to make capital more readily available to small companies. Pub. L. No. 96-477, 94 Stat. 2274 (1980) (codified at scattered sections of the United States Code). *See generally* Definition of Eligible Portfolio Company Under the Investment Company Act of 1940, Investment Company Act Release No. 27,538, 71 Fed. Reg. 64,086 (Oct. 31, 2006); Definition of Eligible Portfolio Company Under the Investment Company Act of 1940, Investment Company Act Release No. 27,539, 71 Fed. Reg. 64,093 (Oct. 31, 2006).

9 72 Fed. Reg. at 400, 404.

on Regulation D offerings to justify providing differing accredited investor standards for investors in such offerings. We also observe that the proposal expands the existing and somewhat confusing categories of qualified or accredited investors determined to be more sophisticated and more capable of bearing varying degrees of investment risk.

CPIC also supports the Commission's goal of preventing fraudulent or misleading conduct by investment advisers against investors in pooled investment vehicles, and we support proposed Rule 206(4)-8 to the extent that it addresses any potential gap in the Commission's authority to bring enforcement actions against unregistered investment advisers who commit fraud. However, this proposal, like the accredited natural person proposal, is limited in scope.

In this letter, CPIC suggests approaches for the Commission's consideration that we believe would help assure that investments in hedge funds and other private placements are limited to sophisticated parties, would afford greater protection to investors in pooled investment vehicles, and would preserve sufficient flexibility so that the alternative investment industry may continue to provide the benefits to the financial markets that investors, academics, and members of the President's Working Group on Financial Markets (including the Commission itself) have acknowledged. In addition, one of our suggestions would address the concern, stated repeatedly by the Commission, that there is a lack of reliable data regarding the number of hedge funds that are currently in operation and the types of investors that they accept. This lack of information (which also is apparent with respect to other issuers of securities distributed under Regulation D) hampers the SEC's ability to ascertain where and how to allocate regulatory resources.

We understand the Commission's interest in moving to address its authority to protect investors in pooled investment vehicles against fraud by investment advisers, as well as to update the accredited investor standards. Our comments below are not intended to delay action on these matters but to suggest ideas for further consideration, perhaps in a future rulemaking or concept release. We also believe the ideas we offer for the Commission's consideration are wholly consistent with the February 22 guidance and principles issued by the President's Working Group on Financial Markets.[10]

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10 Press Release, Dep't. of Treasury, Agreement Among PWG and U.S. Agency Principals on Principles and Guidelines Regarding Private Pools of Capital, (Feb. 22, 2007) *available at* http://www.treasury.gov/press/releases/reports/hp272_principles.pdf.

Modernizing the Accredited Investor Standard

By way of background, certain issuers, including "start-up" enterprises, private equity funds, venture capital funds, business development companies and hedge funds, sell their securities in accordance with Rule 506 of Regulation D[11] under Section 4(2) of the Securities Act of 1933 (the "Securities Act"), in order to ensure that sales of their securities are not deemed to be a public offering and thus not subject to registration requirements. Rule 506 provides, in part, that an offering will not be deemed a public offering if the issuer limits sales of its securities to "accredited investors" and no more than thirty-five persons who are not accredited investors.[12] In brief, accredited investors are persons who are deemed to have the requisite financial means and sophistication to understand and withstand the risks of investment in securities without the protections that registration under the Securities Act would otherwise afford. The Commission, in order to provide bright-line tests for financial sophistication, generally has established minimum amounts for an investor's income, net worth, or investment assets.

With respect to natural persons, Rule 501(a) under Regulation D currently defines an "accredited investor" as any person who meets, or whom the issuer reasonably believes meets, either of the following criteria:

- A natural person whose individual net worth, or joint net worth with their spouse, at the time of purchase exceeds $1,000,000.
- A natural person who had an individual income in excess of $200,000 in each of the two most recent years, or joint income with their spouse in excess of $300,000 in each of those years, and who has a reasonable expectation of reaching the same income level in the current year.[13]

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11 17 C.F.R. § 230.506.

12 17 C.F.R. § 230.506(b)(2). In addition to the accredited investor limitation, the offering may not be effected by means of a general solicitation or advertising, and any non-accredited investors in the issuer must receive disclosures of the same types of information that would appear in Part I of a registration statement filed under the Securities Act. Rule 502(d) of Regulation D also provides that securities purchased pursuant to Rule 506 may not be resold unless they are registered or exempt from registration under the Securities Act. 17 C.F.R. § 230.502(d).

13 17 C.F.R. § 230.501(a).

The Release states that, due to the effects of inflation and an increase in wealth (including real estate values) from the time they were established in the 1980s, the income and net worth tests in the definition of "accredited investor" have become outdated.[14] As a result, according to the Release, private offerings of securities under Regulation D may now be extended to a larger number of natural persons than when the accredited investor standards were established, and therefore the current standards may not be sufficient to safeguard these investors.[15] The Commission's proposal would not make uniform adjustments for investors in all securities distributed under Regulation D, but would revise these standards *only* for investors in one particular sub-type of security - investments in pooled vehicles that are excluded from the definition of an "investment company" pursuant to Section 3(c)(1) of the Investment Company Act of 1940 (the "Company Act")[16] ("3(c)(1) Funds") and that are not "venture capital funds," defined as business development companies (as defined in Section 202(a)(22) of the Investment Advisers Act of 1940) (the "Advisers Act").[17] For investments in such a 3(c)(1) Fund, a natural person would be required to qualify as an "accredited natural person" by meeting either the income or net worth tests currently required for an individual who is an "accredited investor" under Regulation D *and* by owning at least $2.5 million in investments.[18] This required amount of investments would be periodically adjusted for

14 72 Fed. Reg. at 404.

15 *Id.* The Commission's staff estimates that the percentage of United States households that qualify for accredited investor status has increased from approximately 1.87% when the standards were established, to approximately 8.47% in 2003. 72 Fed. Reg. at 406 n.57.

16 15 U.S.C. § 80a-3(c)(1).

17 The proposed rule describes 3(c)(1) Funds that are not "venture capital funds," but then defines the term "venture capital funds" to mean a "business development company" as defined in Advisers Act Section 202(a)(22) (15 U.S.C. § 80b-2(a)(22)) and described *supra* n. 8. 72 Fed. Reg. at 407-408, 414, 416.

18 The proposed rule change would not apply with respect to investments in the other main form of hedge funds, the "3(c)(7) Fund," because such Funds are already restricted to accepting only "Qualified Purchasers" as investors, which, with respect to natural persons, requires ownership of at least $5 million in investments. *See* Company Act §§ 2(a)(51), 3(c)(7); 15 U.S.C. §§ 80a-2(a)(51), 80a-3(c)(7).

inflation, and the proposed rule would value investments differently from other SEC regulations that apply in comparable situations.[19]

The Commission and the Staff in recent years have voiced a range of investor protection concerns regarding hedge funds, such as in the 2003 Staff Report on the *Implications of the Growth of Hedge Funds* (the "Staff Report")[20] and the Commission's release accompanying its proposed hedge fund adviser registration rule.[21] Modernizing the accredited investor standard appears to be aimed at the "retailization" concern, described in the Staff Report as the potential phenomenon of "significant numbers of less sophisticated investors ... investing in hedge funds."[22]

As the Commission considers adoption of the proposal, it is instructive to note that the Commission Staff stated in its 2003 report that it had "not uncovered evidence of significant numbers of retail investors investing directly in hedge funds."[23] There is no information in the Release to indicate that this situation has changed. Therefore, the

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19 The definition of "investments" in the proposed rules at first appears to be the same as the definition of "investments" used in Rule 2a51-1 under the Company Act for purposes of defining a "Qualified Purchaser." 17 C.F.R. § 270.2a51-1. However, the definition has been altered with respect to investments that a natural person owns jointly with a spouse or as part of a shared community interest with a spouse. While Rule 2a51-1 permits all of such investments to be counted in the determination of whether a natural person is a "Qualified Purchaser," the proposed rule would provide that when a natural person acts on their own behalf (and not jointly with a spouse), only one-half of such investments could be counted in the determination of whether they qualify as an accredited natural person.

20 *Implications of the Growth of Hedge Funds, Staff Report to the United States Securities and Exchange Commission* (Sept. 29, 2003), *available at* http://www.sec.gov/spotlight/hedgefunds.htm. The Staff Report noted concerns not only with the test for "accredited investor" status, but also with the retail offering of registered funds-of-hedge-funds and the exposure that individual investors may have to hedge funds through investments in pension plans. Other concerns described by the Report included the protection of hedge fund investors from fraud or deficient disclosure, the methods employed by hedge funds to solicit investors, questionable valuations by advisers of hedge fund portfolios, and a lack of transparency with respect to advisers' valuation policies. *Id.* at 79-87.

21 Registration Under the Advisers Act of Certain Hedge Fund Advisers, Investment Advisers Act Release No. 2,266, 69 Fed. Reg. 45,172 (July 28, 2004).

22 Staff Report, at 80.

23 *Id.* at 80.

Commission's concern that the accredited investor standard may no longer suffice to protect investors is *prospective* in nature. The proposed rule change therefore presents challenges in that it represents only the Commission's best guess as to what an appropriate standard might be, rather than one based upon empirical data.

Of course, the Commission also has expressed concerns about a lack of accurate information about how many hedge funds operate in the United States, their assets and who controls them, which the Commission says has impeded its ability to formulate public policy.[24] This lack of data also presents challenges to the Commission in formulating the scope of its revised accredited investor standard.

To illustrate, although the proposal to revise the "accredited investor" standard is focused exclusively on 3(c)(1) Funds that are not business development companies, the Commission acknowledges that it cannot state with certainty how many such entities are currently in operation. The Release explains that in order to estimate the number of 3(c)(1) Funds that might be affected by the proposal, the Staff reviewed the 19,250 filings submitted to the Commission on Form D in 2006, but that "Form D does not contain sufficient information ... to determine whether a filer is an operating company, a 3(c)(7) Pool or a 3(c)(1) Pool."[25] The Staff estimates that about twenty percent (or 3,850) of these filings were made by 3(c)(7) or 3(c)(1) Funds and that about ten percent of that number (or 385) were made by 3(c)(1) Funds, although the bases for these estimates are not stated.[26] Still further, the Commission has not indicated whether it has the data to know how many of these 385 filers were not also business development companies. Finally, the Commission cannot ascertain how many of these potential 3(c)(1) Funds already impose higher suitability standards than basic accredited investor status. Indeed, it seems likely that they would do so, for in order for a manager to charge an incentive fee (which most hedge fund managers do) to investors in a 3(c)(1) Fund, such investors must not only be "accredited," but must also be "Qualified Clients" as defined in Rule 205-3(d)(1).[27] Accordingly, the Commission does not know how many issuers and

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24 *Id.* at 77-78.

25 72 Fed. Reg. at 409 n. 83,413 n. 105.

26 *Id.*

27 17 C.F.R. § 275.205-3(d). In brief, unless a natural person is an officer of the Fund, they may only be deemed a Qualified Client if (a) they have at least $750,000 under the management of the investment adviser in question, (b) the adviser reasonably believes that they have a net worth

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investors will be affected by the proposed rule change, nor will it be able to gauge the success or failure of its efforts if the proposal is implemented.

CPIC Proposal: Give Further Consideration to Accredited Investor Standard

CPIC agrees with the Commission that the qualifications required for "accredited investor" status should be updated. Indeed, we testified in support of this concept last year.[28] Yet, if the Commission is truly concerned that current rules allow offerings to natural persons that are not sufficiently sophisticated or able to withstand financial risks without the protections otherwise afforded by the registration provisions of the Securities Act, then the Commission should evaluate whether it is advisable to update the standards for other Regulation D private placements, and not just those of one particular type of issuer. Moreover, we believe that revisions to the accredited investor standards could be made less complex and more consistent with comparable SEC rules.

Put another way, if the Staff's estimate that 3,850 of the 2006 Form D filers were hedge funds is correct, then it is also correct that there were 15,400 filers that were not hedge funds. Under the Commission's proposal, these 15,400 issuers would be free to solicit investors that meet the accredited investor thresholds of the 1980's. CPIC's expertise does not extend beyond pooled investment vehicles, so we take no position on the appropriate accredited investor standard for these other Form D filers. We believe an appropriate question for the Commission to address, however, is whether such issuers, which may include non-diversified "start-up" ventures, are any less speculative or hard to understand than a securities trading pool with fewer than 100 owners.

We believe the same questions should be asked about the rationale for only raising the thresholds for purposes of investments in 3(c)(1) Funds that are not business development companies. The Release states that this exclusion for business development companies is meant to preserve their ability to provide managerial assistance and capital

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(including assets held jointly with a spouse) of more than $1,500,000, or (c) the adviser reasonably believes that they are a Qualified Purchaser. *Id.*

28 *Hedge Fund Industry: Hearing Before the Subcomm. on Securities and Investment of the S. Comm. on Banking, Housing, and Urban Affairs* (May 16, 2006) (statement of James Chanos, Chairman, Coalition of Private Investment Companies), *available at* http://banking.senate.gove/_files/ACF82BA.pdf.

to small firms. Yet this rationale does not relate in any way to the stated motivation for this proposed rule change, which is to ensure that potential investors are able to understand and withstand the risks of an investment. Indeed, the Commission has not identified any reason to believe that business development companies are any less risky or difficult for an investor to analyze than a 3(c)(1) Fund. On the contrary, such issuers are frequently non-diversified companies that feature a high degree of risk.

Establishing the Proper Quantitative Standard

Determining the proper quantitative standards for a natural person to qualify as an accredited investor is a separate matter. CPIC recognizes that the accredited investor standard serves primarily a public policy function more than a pure economic function. This standard is a proxy for the Commission's best estimate for an investor who either has the knowledge to understand the risks associated with investing without the protection afforded by Securities Act registration or who has the financial capacity to hire expert advice sufficient to apprise the investor of the risks associated with such an investment. Consequently, any such standard will be rough justice at best and must be viewed in such a context. There is no single standard that could possibly encompass all of the individual exceptions to the rule.

We note that there are alternatives the Commission could consider. Rather than add a new category of named investor and a complicated minimum investment ownership component to an already complex set of regulations, the Commission could consider a direct approach by raising the existing income and net worth tests, while excluding the value of a person's home and/or place of business from the calculation of net worth.[29]

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[29] To this end, in order to exclude the value of real estate that is not held for investment purposes from the calculation of net worth, the Commission should, for the sake of consistency, continue to use the standard employed for that purpose in Rule 2a51-1 under the Company Act with respect to the definition of a "Qualified Purchaser. Rule 2a51-1(b)(2) includes real estate held for investment purposes within the definition of investments. 17 C.F.R. § 270.2a51-1(b)(2). Real estate is not considered held for investment purposes if it used as a place of business or for "personal purposes." Rule 2a51-1(c)(1); 17 C.F.R. § 270.2a51-1(c)(1). The term "personal purposes" is derived from the Internal Revenue Code. In brief, residential property is not deemed to be used for "personal purposes" and may be treated as an investment if it is not treated as a residence for tax purposes. This allows prospective investors to determine if residential real estate is an investment based on the same tests used for determining whether certain property-related expenses are tax-deductible. *See* Privately Offered Investment Companies, Investment Company Act Release No. 22,597, 62 Fed. Reg. 17,512, 17,516 (Apr. 9, 1997) (adopting Rule 2a51-1).

For example, the Commission could round upwards the figures identified by the Commission's Office of Economic Analysis ("OEA") to adjust for inflation (*i.e.*, $2 million [net worth]; $400,000 [individual income]; $600,000 [joint income]).[30]

Alternatively, or in addition, the Commission could consider, instead of a minimum investment ownership requirement, a cap, expressed as a percentage of net worth, on the amount of a natural person's investment in any one private offering. This limitation could easily be added to the subsections of Rule 501 that apply to natural persons, and would be easy for issuers to administer. Institutional investors and experienced personal investment advisers already employ comparable limitations as prudential safeguards.[31]

Complexities of the Accredited Natural Person Proposal

We note that the proposal also has unnecessary complexities. For example, the proposed investment ownership requirement is very similar to the familiar investment ownership test that is presently employed for purposes of the definition of a Qualified Purchaser, but the proposed rules' definition of "investment" and valuation with respect to spousal assets are actually quite different.[32] Given time, we believe it is almost a certainty that the similarity will result in mistakes by investors and Fund managers which, though made in good faith, may result in a potential violation of the securities laws, and the issuer's loss of the exclusion from coverage of the Securities Act and Company Act. In addition, requiring the minimum investment ownership amount to be periodically adjusted for inflation is unduly complex and a burden that will require fund managers to revise the questionnaires that they use to screen investors with new and confusing

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30 We note that the Commission's Office of Economic Analysis estimated the number of households that would qualify as "accredited investors" if the proposal were adopted as it stands. The Commission should publish any estimate by OEA of the number of households that would qualify as "accredited investors" if the Commission simply raised the income and net worth tests to these levels (excluding, of course, the values of homes and places of business).

31 For example, pursuant to its investment policies, the California Public Employees' Retirement System (CalPERS) limits investments in hedge funds to a percentage of the funds that it allocates for investment in given asset categories. *See* CalPERS *Statement of Investment Policy for Hybrid and Hedge Fund Investment Vehicles – Externally Managed* (Feb. 18, 2003) *available at* http://www.calpers.ca.gov/eip-docs/investments/policies/alternative/hyb-hed-fun-inv-vhs-ex-mn.pdf.

32 See, *supra at n. 19.*

questions -- especially if the Commission retains the proposal to define "investments" one way for an existing named category of investor and a second way for the new named category of investor.

As Commissioner Atkins noted at the Commission meeting announcing its proposed new "accredited natural person" category, there is already a confusing number of defined categories that are meant to serve the same purpose: describing investors with a high degree of sophistication and the financial wherewithal to withstand a greater degree of risk. The proliferation of different categories and tests of wealth has become overwhelming, and now results in subscription agreements that confuse and irk investors.

As part of an overall review of this area, the Commission should consider paring back on the Byzantine complexity of the current set of similar and overlapping, yet different investor qualification standards that apply under the federal securities laws. The objective should be to reduce transactions costs and thereby improve economic efficiency while maintaining investor protections. The Commodity Futures Trading Commission has already made significant strides in this regard by aligning certain of its commodity pool exemption rules with SEC Rules. We recommend that the Commission maintain these investor qualification standards in a simple and relatively uniform fashion.[33]

For Further Consideration: Revise Form D

To the extent the Commission is focusing on the standards for investors in Regulation D offerings, it may wish to consider revisions to Form D itself, to provide the Commission and other Federal regulators with some of the critical "census" data it has

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33 If the Commission moves forward on its current rulemaking, we also recommend that the Commission recognize the knowledgeable employees of an issuer as accredited investors (similar to the approach of Rule 3c-5 under the Company Act, 17 C.FR. § 270.3c-5) without resort to net worth or income tests. Such employees, due to their positions with the issuer, have sufficient knowledge as to the operations and status of the issuer to provide them with the requisite degree of sophistication as to the nature of the investment. We also recommend that a "grandfather clause" be included in any revisions to the accredited investor standards adopted pursuant to this proposal. Without such a provision, managers will be required to re-analyze the financial status of current investors in order to ascertain whether they may place new sums where they are already investors. Such re-reviews would yield no significant investor protections. In addition, we suggest the Commission amend its regulations to provide that a "Qualified Institutional Buyer" (as defined in Rule 144A, 17 C.F.R. §230.144A) falls within the definition of a "Qualified Purchaser" in Section 2(a)(51)(A) of the Company Act. 15 U.S.C. § 80a-2(a)(51)(A).

said that it lacks with respect to pooled investment vehicles that invest in securities. The *Goldstein* Court struck down a registration rule that was meant to provide the SEC with census data regarding hedge funds and their advisers, and to provide hedge fund investors with a certain degree of protection through SEC oversight and inspections.[34] Comments filed in connection with the Commission's adviser registration proposal argued at the time that the Commission could achieve its interest in obtaining census and other data without resorting to a full-blown registration rule.[35] The SEC can no longer obtain this information through a registration requirement, unless Congress provides appropriate authority.

We do not believe legislation in this area is the only choice, and we would not recommend it when other alternatives are available. As an example, the Commission could consider the utility of modernizing the filing requirements associated with Regulation D offerings so that the filings yield census information regarding pooled investment vehicles that offer securities using Form D.[36] As a coalition of private investment companies, we do not take a position on whether the Commission needs this information on issuers other than pooled investment vehicles. However, if it chooses to address the lack of information on Form D filers noted in the Release, the Commission could consider revising Form D to require the submission and periodic updating of information from all pooled investment vehicles[37] utilizing Form D, such as the following (much of which is already required on Form D):

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34 Registration Under the Advisers Act of Certain Hedge Fund Advisers, Investment Advisers Act Release No. 2,266 69 Fed. Reg. 45,172 (July 28, 2004).

35 For example, comments filed by Kynikos Associates LP, recommended that the SEC, by rule, make the safe harbor counting rule utilized by hedge fund managers under SEC Rules 203(b)(3)-1 and 222-2 under the Advisers Act, which implement the counting rules of Sections 203(b)(3) and 203A of that Act, contingent upon written receipt by the SEC of certain basic census information about the fund, as well as certification by the fund's managers of certain key investor protections in the Advisers Act and related SEC rules. *See* Letter from James Chanos to Jonathan Katz, SEC (Sept. 15, 2004) *available at* http://www.sec.gov/rules/proposed/s73004/s73004-52.pdf).

36 Of course, pooled investment vehicles also may be offered pursuant to Section 4(2) of the Securities Act and not pursuant to Regulation D.

37 The Coalition would note that the Commission may also wish to consider improving the information available generally from all issuers utilizing Form D, but for the purposes of this letter, we confine our recommendations to pooled investment vehicles.

- The name and address of the issuer, its legal form and its date and jurisdiction of formation;
- The names of senior management and control persons;
- The types of securities being issued;
- The issuer's prior names (if any);
- The States where the issuer's investors are located;
- The number of investors and amounts of their investments in each state;
- The issuer's disciplinary history under state and federal securities laws and regulations; and
- The payment of any referral or placement fees, together with the identities of placement agents that are paid to offer and sell interests in the issuer, and whether such placement agents are registered broker-dealers.

For pooled investment vehicles in particular, we believe the following additional information would be useful to the Commission and investors:

- The identities of the Fund's manager, custodians, and independent auditors;
- The Fund's fee structure and expense information;
- The Fund's assets under management;
- The Fund's general categories of investment strategies and assets;
- Information as to any exemptions that the Fund relies upon under the Company Act and/or Commodity Exchange Act; and
- The Fund's policies as to the use of "soft dollars" and brokerage allocations.

This basic census data could be supplied through a modified, web-based version of Form D that could be shared with other appropriate regulatory authorities, such as the members of the President's Working Group on Financial Markets, state securities regulators, the National Association of Securities Dealers and the National Futures Association. Because this enhanced Form D information would be available to state regulators, the SEC could also take action on its long-stalled rulemaking relating to preemption of state law for sales of securities to qualified purchasers, as mandated by the

1996 National Securities Market Improvement Act ("NSMIA").[38] We offer these ideas for the Commission's consideration only to the extent it believes it currently has insufficient census data. We encourage the Commission to work with investors and the industry to find reasonable means to achieve its policy goals.

Proposed New Rule 206(4)-8

Proposed new Rule 206(4)-8 under the Advisers Act would prohibit investment advisers, whether or not they are required to be registered, from making false or misleading statements to, or otherwise defrauding, investors or prospective investors in pooled investment vehicles. As noted earlier in this letter, this proposed rule is intended to clarify the Commission's authority under the Advisers Act to protect investors and potential investors in pooled investment vehicles in light of any potential ambiguity caused by the *Goldstein* decision.[39] The Commission has stated that it believes the *Goldstein* opinion could be read to support an argument that the anti-fraud provisions of the Advisers Act in subsections (1) and (2) of Section 206, which prohibit advisers from defrauding "clients," do not apply to investors in pooled investment vehicles. The Commission, therefore, proposes a new antifraud rule using its rulemaking authority under Subsection 206(4), which gives the Commission rulemaking authority to "prescribe means reasonably designed to prevent . . . acts, practices or courses of business that are fraudulent, deceptive or manipulative" by any investment adviser.

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38 As amended by NSMIA, Section 18 of the Securities Act preempts state registration and review of offers or sales of securities to qualified purchasers "as defined by the Commission by rule." Securities Act § 18(b)(3); 15 U.S.C. § 77r(b)(3). The Commission proposed a rule to define the term "qualified purchaser" for this purpose in December 2001 but has never acted upon it, due in part to objections by state regulators. Defining the Term "Qualified Purchaser" Under the Securities Act of 1933, Release No. 33-8041, 66 Fed. Reg. 66,839 (Dec. 27, 2001); *see* Comments of Joseph P. Borg, President and Director, Alabama Securities Commission, on behalf of the North American Securities Administrators Association, Inc. (Mar. 4, 2002), available at http://www.sec.gov/rules/proposed/S72301/borg1.htm.

39 The Court in *Goldstein* considered the meaning of the term "client" for purposes of Section 203 of the Advisers Act (15 U.S.C. § 80b-3) which, in relevant part, exempts from registration under the Advisers Act any adviser who has fewer than fifteen clients. The court rejected the Commission's argument that the "clients" of an investment adviser managing a pooled investment vehicle are individual investors in the pool. 451 F.3d at 878-84.

The proposed new rule would apply to all investment advisers as defined in the Advisers Act, whether or not they are required to be registered,[40] but it would not apply to those financial managers that the Advisers Act specifically excludes from the definition of "investment adviser," such as banks or trust companies. We believe that the coverage of the proposed rule in this regard is appropriate, and we support adoption of the rule. Even if they are exempt from registration, investment advisers should be subject to this prohibition against abusive conduct.

Additional Observations on the Commission's Authority under Section 206

In addition to our support for the proposed new antifraud rule, CPIC wishes to offer further comments on the nature of the Commission's authority under Section 206. We offer these comments in light of the threat of action by individual states who may believe there is an investor protection gap at the federal level[41] and also in response to suggestions that the only way to address that gap is through federal legislation, empowering the Commission to register hedge fund advisers. We think neither action is necessary at this time.

As the Commission notes in the Release, Congress amended the Advisers Act in 1960 to make the antifraud provisions applicable to all investment advisers, whether registered or not, and to give the Commission express rulemaking authority over unregistered advisers in subsection 206(4).[42] Using this authority -- to "prescribe means reasonably designed to prevent" fraudulent and deceptive acts, practices or courses of business[43] -- the Commission may write rules for the prevention of fraud without resort to creation of a registration regime. For example, the Commission has the power to promulgate minimum protections for hedge fund investors -- protections that are "best

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40 72 Fed. Reg. at 401.

41 *See, e.g.*, S.B. No. 1171, 2007 Leg., Jan. Sess. (Conn. 2007)("An Act Concerning Hedge Funds").

42 Pub. L. No. 86-750, §9, 74 Stat. 885 (1960).

43 The statutory provision on which the Commission relies as authority for its proposed new antifraud rule states: "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. The Commission shall, for the purposes of this paragraph (4) by rules and regulations define, and prescribe means reasonably designed to prevent, such acts, practices, and courses of business as are fraudulent, deceptive, or manipulative." 15 U.S.C. § 80b-6.

practices" for any reputable hedge fund manager and which reduce the opportunities for unscrupulous managers to abscond with investor funds or defraud investors with misvaluations.[44] While proposed new Rule 206(4)-8 will allow the Commission to bring after-the-fact enforcement actions in cases of fraud by unregistered (as well as registered) advisers, an approach in which the Commission prescribes minimum practices as means reasonably designed to prevent fraud could have a significant investor protection impact.

The Commission has used this authority in the past to write prophylactic rules applicable to unregistered, as well as registered, investment advisers. For example, in 1962, the Commission issued Rule 206(4)-2 which, in a previous form, stipulated that it was a fraudulent, deceptive or manipulative act, practice or course of business under Section 206(4) of the Advisers Act for an investment adviser who had custody or possession of client funds or securities to take any action with respect to such funds or assets unless the securities were segregated and kept in a safe place, funds were deposited at a bank, periodic account statements were provided to clients, and the funds and securities were subject to surprise examination by an independent accountant.[45] Other rules promulgated pursuant to Section 206(4) that once applied to all investment advisers, whether registered with the Commission or not, were prohibitions on certain abusive advertising practices (Rule 206(4)-1),[46] and requirements to disclose information relating to an adviser's disciplinary history and financial condition (Rule 206(4)-4).[47]

In 1997, however, the Commission decided to confine the application of these rules to SEC-registered investment advisers. As the Commission explains in the Release, it removed unregistered advisers from the coverage of these rules in order to correspond to amendments to the Advisers Act by Title III of NSMIA (the "Investment Advisers

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44 *See e.g.* SEC v. Samuel Israel III, SEC Litigation Release No. 19,406, 2005 WL 2397234 (Sept. 29, 2005) (managers of a group of hedge funds known as the Bayou Funds grossly exaggerated claims regarding funds' performance, when in fact, the funds had never posted a year-end profit, and misappropriated funds); SEC v. Haligiannis, SEC Litigation Release No. 18,853, 2004 WL 1908196 (Aug. 25, 2004) (fund and its general partners systematically defrauded investors by misrepresenting performance to investors and potential investors and distributing phony account statements that showed fictitious gains and account balances).

45 17 C.F.R. § 275.206(4)-2; *Custody or Possession of Funds or Securities of Clients,* Release No. 40IA-123 Fed. Reg. 2,149 (Mar. 6, 1962).

46 17 C.F.R. § 275.206(4)-1 (1996).

47 17 C.F.R. § 275.206(4)-4 (1996).

Supervision Coordination Act"),[48] which, in brief, delegated the responsibility for regulating smaller advisers to state securities authorities. The Commission took this action as a matter of comity with the states, notwithstanding the fact that Congress intended that the Commission would continue to apply its general antifraud authority under Section 206 to state-registered advisers.[49]

We understand that the Commission must be cognizant of the scope of its statutory authority, as well as its policy of coordination with State regulators. Nonetheless, because Section 203 of the Advisers Act exempts investment advisers with fewer than fifteen clients from registration, an investment adviser with a small number of clients (including pooled investment vehicles) that manages large amounts of investor assets could, depending on the requirements of applicable state law, operate without being subject to the minimal types of investor protections that laws such as the Advisers Act might otherwise afford.[50] Thus, it may be appropriate for the Commission to examine the extent to which investors in private investment pools are not protected by federal or state requirements and whether the industry cannot, on its own, adopt best practices in critical areas. The Commission could then consider whether it should exercise its rulemaking authority under Section 206(4) of the Advisers Act and apply certain base-level requirements to advisers of funds who are not registered under state or federal law, or who manage (or purport to manage) over $25 million in private investment funds.

For example, any investment adviser to a pooled investment vehicle should hold the assets that they control at, and make transfers of such assets only through, a bank or trust company, broker-dealer, futures commission merchant, or certain well-regulated foreign banks and broker-dealers. Placing custody of fund assets with a bank, trust company or broker-dealer is a sound practice that is currently required of investment

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48 72 Fed. Reg. at 402. *See also* Rules Implementing Amendments to the Investment Advisers Act of 1940, Investment Advisers Act Release No. 1633, 62 Fed. Reg. 28,112 (May 22, 1997).

49 72 Fed. Reg. at 402 n.17 (citing S. Rep. No. 293, 104th Cong., 2d Sess. 3-4 (1996) at 4). *See also* 62 Fed. Reg. at 28,128, n.172, Rules Implementing Amendments to the Investment Advisers Act of 1940, Investment Advisers Act Release No. 1601, 61 Fed. Reg. 68,480, 68,481 (Dec. 27, 1996).

50 Specifically, Section 203 exempts from registration any investment adviser who during any twelve-month period has fewer than fifteen clients and that does not holds itself out to the public as an investment adviser or act as an adviser to any mutual fund. 15 U.S.C. § 80b-3.

advisers that are registered or required to be registered under the Advisers Act.[51] Such a custody requirement should not impose any undue regulatory burdens. It is simply reflects good practice by any reputable adviser to a pooled investment vehicle.

Similarly, using its antifraud rulemaking authority, the Commission could consider extending to such unregistered advisers certain of the key investor protections that presently apply only to investment advisers that are registered or required to be registered with the Commission. As with the custody rule, some of these requirements were previously applied, in some fashion, to advisers that are not registered with the Commission. More importantly, they are fundamentally sound ways of doing business that would not impose substantial burdens on legitimate private investment funds or their advisers. These include:

- Requiring private investment pools -- whether or not their advisers are required to register with the Commission -- to undergo an annual audit by an independent accounting firm and to provide their investors with audited financial statements on a yearly basis, and un-audited financial reports on a quarterly basis.[52] Such requirements would serve to detect and deter fraud and would give investors assurance that the financial information that they receive from a Fund is fair and accurate.

- Requiring that prospective fund investors receive information relating to the adviser's disciplinary history and financial condition, similar to the disclosures required by Rule 206(4)-4.[53]

- Requiring advisers, whether or not registered, to adopt and disclose written supervisory and compliance policies and procedures and codes of ethics.[54] Such policies and procedures, at a minimum, would address the disclosure of financial arrangements between advisers and other interested parties such as prime brokers, the disclosure of an adviser's allocation policies so investors know how an adviser with multiple clients allocates investment opportunities,

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51 Advisers Act Rule 206(4)-2; 17 C.F.R. § 275.206(4)-2.

52 *See* id.

53 17 C.F.R. § 275.206(4)-4.

54 *See* Rules 204A-1, 206(4)-7; 17 C.F.R. §§ 275.204A-1, 275.206(4)-7.

> and disclosure of objective standards for the calculation of unit values for investor reports, fees, admissions and withdrawals.[55]

The requirements generally discussed above would be non-intrusive, consistent with best practices and impose little or no burden on advisers. However, because they depart from the proposed rule, they should be considered and proposed only after additional input from investors, the hedge fund industry, and others and in connection with a concept release or a new SEC rulemaking.

Broader Issues for Regulators and Policy Makers

When CPIC testified before Congress last year, we identified a number of issues for legitimate focus and review by Congress and financial regulators. Certain investor protection issues, such as the issues discussed in this letter, are best addressed by the Commission, acting pursuant to its statutory authority. Others, such as systemic risk, are best addressed through coordinated review and consultation of members of the President's Working Group on Financial Markets, of which the Commission is a member. In this regard, we were encouraged to review the recent report by the Working Group on Private Pools of Capital, which identified a number of standards and practices for all market participants -- including private pools of capital, pool investors and fiduciaries, counterparties and creditors -- as well as regulators and supervisors.

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55 *See generally* Compliance Programs of Investment Companies and Investment Advisers, Investment Advisers Act Release No. 2204, 68 Fed. Reg. 74,714, 74,716 (Dec. 24, 2003). We do not suggest that all the rules that apply to investment advisers that are registered or required to be registered with the Commission should be extended to hedge fund managers. Rather, the Commission should consider select protections that would help prevent flagrant or criminal misconduct, such as theft. To illustrate, we believe that hedge fund advisers should not have to adopt and disclose proxy voting policies, as do investment advisers that are registered or required to be registered. Rule 206(4)-6; 17 C.F.R. § 275.206(4)-6. This requirement does not serve the purpose of preventing flagrant misconduct, and if investors in private placements care for such information, they may always ask for it.

Conclusion

We thank the Commission for this opportunity to provide our thoughts with respect to this latest of its continuing efforts to protect investors within a framework of flexible regulation. We urge the Commission to carefully consider the options presented in these comments, and we would be happy to discuss them with the Commission at any time.

Sincerely,

James Chanos
Chairman

cc: The Honorable Christopher Cox, Chairman
The Honorable Paul S. Atkins, Commissioner
The Honorable Roel S. Campos, Commissioner
The Honorable Annette L. Nazareth, Commissioner
The Honorable Kathleen L. Casey, Commissioner
Andrew J. Donohue, Director, Division of Investment Management