SIFMA
Securities Industry and
Financial Markets Association

March 9, 2007

Ms. Nancy M. Morris
Secretary
Securities and Exchange Commission
100 F. Street N.E.
Washington D.C. 20549-9303

Re: Release No. 33-8766, File No. S7-25-06, "Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles; Accredited Investors in Certain Private Investment Vehicles."

Dear Ms. Morris:

The Securities Industry and Financial Markets Association ("SIFMA")[1] appreciates the opportunity to comment on the above referenced proposal, which is designed to address investor protection concerns relating to investments in pooled investment vehicles, including hedge funds. Specifically, the Commission seeks to accomplish this by increasing accredited investor standards for investing in private investment vehicles[2] that are exempt from registration as investment companies pursuant to Section 3(c) (1) of the Investment Company Act of 1940; and by adopting a new anti-fraud rule under the Investment Advisers Act of 1940 ("Advisers Act") to resolve certain uncertainties created by a recent court decision[3] regarding the Commission's anti-fraud authority under the Advisers Act.

SIFMA supports these initiatives, and in the following discussion, offers a few recommendations which we believe will make the proposed rules more likely to achieve their objectives without causing unintended consequences.

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[1] The Securities Industry and Financial Markets Association brings together the shared interests of more than 650 securities firms, banks and asset managers. SIFMA's mission is to promote policies and practices that work to expand and perfect markets, foster the development of new products and services and create efficiencies for member firms, while preserving and enhancing the public's trust and confidence in the markets and the industry. SIFMA works to represent its members' interests locally and globally. It has offices in New York, Washington D.C., and London and its associated firm, the Asia Securities Industry and Financial Markets Association, is based in Hong Kong.

[2] For convenience, the term "private hedge funds" will be used in the remainder of this letter to collectively describe investment vehicles that would be subject to the proposed accredited natural person standard.

[3] Goldstein v. SEC, 451 F.3d 873 (D.C. Cir. 2006).

Modification to Accredited Investor Standard

We agree with the Commission's proposal to modify the accredited investor standard for natural persons investing in private hedge funds and regard it as consistent with the principle articulated recently by the President's Working Group on Financial Markets that "the risks associated with direct investment in [private investment] pools are most appropriately borne by investors with the sophistication to identify, analyze and bear these risks."[4] During, and following, the Commission's Hedge Fund Roundtable in May, 2003, significant concern was expressed that the private hedge fund accredited investor standards pursuant to Rule 501(a) under Regulation D of the Securities Act of 1933, established more than 20 years earlier, were no longer an appropriate benchmark given the general impact of inflation and the fact that escalating real estate prices had caused home equity to become a much greater percentage of the total net worth of many American households.[5] New proposed rules 509 and 216 seek to address this by layering on top of the current Rule 501(a) standard, a requirement that an accredited natural person must own at least $2.5 million of investments, exclusive of home equity.[6]

Given the fact that home equity is an illiquid asset, and often constitutes the great majority of total household net worth, we applaud the Commission's proposal to exclude it from consideration in meeting the proposed accredited natural person standard. Home equity makes little contribution toward determining either an investor's investment sophistication or ability to withstand risk, which the accredited investor standards are intended to reflect. For example, a 60 year old married couple who have paid off the mortgage on a house with a current market value of $400,000, and accumulated $600,000 in retirement accounts over a 35 year working career, would clearly not seem to be appropriate candidates to invest in private hedge funds.

While we believe that the appropriate course of action is clear with respect to excluding home equity, we think the issue is more complex with respect to requiring an investor to hold $2.5 million of investments. From both an intuitive and statistical standpoint, it appears logical to increase investment thresholds. It is more difficult to determine precisely what level is appropriate. For example, would it be justifiable to exclude a 35 year old business professional with $2 million of qualified investments from investing in a private hedge fund? Examples such as this suggest that a threshold lower than the proposed $2.5 million may be more appropriate, particularly as the proposal carves out home equity and contains an inflation escalator provision. We recommend

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4 President's Working Group on Financial Markets, Agreement among PWG and U.S. Agency Principals on Principles and Guidelines Regarding Private Pools of Capital (February 22, 2007) <available at http://www.treasury.gov/press/releases/reports/hp272_principles.pdf >.

5 In a comment letter filed with the Commission on July 7, 2003, one of SIFMA's predecessors, the Securities Industry Association, supported recommendations made during the SEC Hedge Fund Roundtable, that accredited investor standards be tightened.

6 On p.17 of the proposing release, the Commission notes that the increase in investor wealth is due in part to the increase in value of personal residences since 1982 when the current accredited investor requirement was adopted.

that the Commission consider adopting, for purposes of the accredited natural person definition, a requirement of $1.5 million of investments, which would be similar to the $1.5 million net worth requirement applicable to "qualified clients" of an adviser under Rule 205-3 of the Advisers Act relating to charging of performance fees. This would provide a more flexible yardstick for investor eligibility while providing greater consistency among investor eligibility standards.[7]

We commend the Commission for limiting application of the proposed accredited natural person standard only to private hedge funds seeking to rely upon a Section 3(c)(1) exemption. As has been often noted, ordinary retail investors have traditionally found it very difficult to diversify their portfolios beyond conventional stocks and bonds. Alternative forms of investments, such as hedge funds, were simply not available, for understandable reasons. However, the relatively new phenomenon of registered "funds of hedge funds" provide an opportunity for retail customers to obtain additional diversification.[8] Consequently, it would be inappropriate to apply the heightened financial eligibility tests to such investment vehicles.[9]

We also wish to address certain other issues related to the application of the proposed natural accredited person standards.

1. <u>Grandfathering Protection</u> - If the proposed accredited natural person standards, or some modified version are adopted, investors who met the prior standard, but not the new one, would not be required to liquidate previous purchases, but would be unable to make additional purchases, at least if the private hedge fund relied on Regulation D. We believe such restrictions are unwarranted. First, it is common for such funds to provide for, or even contractually require, periodic additional investments. Indeed, some investors negotiate for the right to purchase additional interests to prevent dilution in the

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[7] More generally, we urge that the Commission promote greater uniformity among investor eligibility standards where practicable and consistent with investor protection. Our members' businesses are complicated by the fact that, depending on the circumstance or investment, they need to determine whether a customer fits into any one or several categories of investor eligibility, including "accredited investor" (under Regulation D), "accredited natural person" (as proposed), "qualified purchaser" (under Investment Company Act of 1940 Section 2(a)(51)), "qualified client" (under Advisers Act Rule 205-3), "qualified eligible participant" (under Commodity Exchange Act Regulations Section 4.7(a)(1)(ii)), "institutional investor" (under NASD Rule 2211(a)(3)), and owner of an "institutional account" (under NASD Rule 3110(c)(4) and MSRB Rule G-8). The standards for eligibility under these investor categories vary considerably, making it burdensome for firms to administer and ensure compliance.

[8] In this connection, we note the recent speech by Commissioner Campos: "To me, listed funds of hedge funds would be one way to provide all investors with access to the benefits of hedge fund strategies and diversification, while simultaneously providing investors with an important layer of investment protection and oversight." Speech by Commission Roel C. Campos, Remarks Before the Hedge Fund Institutional Forum Corporate Funds Roundtable, March 5, 2007.

[9] We note that the Commission has received hundreds of comment letters from the general public, the great majority of which are extremely critical of the inability of retail investors without a substantial net worth to access the types of strategies and opportunities for portfolio diversification that hedge funds provide. Ensuring that retail investors can invest in funds of hedge funds would seem to largely remedy this complaint.

event the fund sells additional interests. We believe the proposal should accommodate such arrangements by including a "look back" provision that will deem such investments to have been made at the time of the original investment.

Second, such investments may be made as part of an overall asset allocation plan that provides for periodic re-balancing through purchases or sales. A proscription on additional purchases could thus disrupt the investor's financial plan and objectives. We therefore recommend that the proposal be modified to permit investors to make additional investments in funds in which they held positions prior to the effective date of any new accreditation standards.

2. Spousal Assets Calculation - We respectfully recommend that the Commission continue to allow 100% of spousal assets to be included in any calculation for determining accreditation status, regardless of whether the investment is made individually or jointly. In many instances, investments are made or held individually by married couples for compelling financial and estate planning reasons, or because of legal requirements, such as with respect to IRAs and other retirement accounts where assets cannot be invested through a joint account. We see no rationale for impairing the ability of spouses to qualify for accredited natural person status under such circumstances.

3. Knowledgeable Employees – The exclusion for knowledgeable employees contained in Rule 3c-5 (b)(1) of the Investment Company Act of 1940 should remain in place regardless of any modifications to accredited investor standards. We are not aware that the exclusion has worked to the detriment of such employees, and their position certainly assures, at least as well as any financial means test, that they have the sophistication to fully evaluate the fund's risks and rewards. Furthermore such investments facilitate a fund's ability to better align its employees interests with those of investors.

Anti-fraud Rule Proposal 206(4)-8

We strongly support the Commission's recent efforts to clarify "fraud" under the federal securities laws, including the concept of scienter in private litigation,[10] but are concerned that proposed Rule 206(4)-8 is overbroad in ways that run counter to the Commission's efforts in this regard and misdirected in two respects.

First, the proposed rule fails to differentiate the roles played by an investment adviser qua investment adviser to a private fund, and the separate and distinct role the adviser (or any associated persons) may play as the managing member or general partner of the fund. In the context of fraud liability, we are concerned that the proposed rule might be read as attributing to an investment adviser communications made by a private fund (or its other service providers) to current or prospective investors on the theory – rejected by the D.C. Circuit – that those prospective or current investors are

[10] *See, e.g.,* See Brief of the SEC, Amicus Curiae (February 2007) in *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, http://www.sec.gov/litigation/briefs/2007/tellabsbrief.pdf.

clients for purposes of the Advisers Act. If the Commission proceeds to adopt an anti-fraud rule along the lines proposed, it should provide appropriate guidance on the types of communications or courses of conduct that would, as well as those that would not, subject an investment adviser to liability under the new rule. This guidance should also address circumstances where such acts are directed or initiated by other service providers or by the fund's board, or acts approved or ratified by the board.

Second, we question the need for the proposed rule to create a new anti-fraud standard without *scienter* or intent as an essential element. Increasing, and we think legitimate, focus is being placed upon the adverse impact upon the competitiveness of U.S. financial markets of our broad and yet amorphous standards for fraud liability. We are concerned that global money managers may increasingly eschew accepting U.S. natural persons as clients if they perceive applicable enforcement and liability standards to be vaguely defined and detached from traditional concepts of intent. Global public offerings have increasingly excluded U.S. persons because of concerns about the U.S. regulatory environment.[11] We therefore urge the Commission to reconsider creating a new standard for fraud liability without the traditional concept of intent as an essential element.

Conclusion

SIFMA reiterates its support for the rule initiatives, but respectfully urges the Commission to carefully consider our comments and suggestions. SIFMA would be happy to discuss our letter with the Commission or the Staff in greater detail. If you have any questions, please contact the undersigned at (202) 434-8440 or Michael Udoff at (212) 618-0509.

Sincerely

Ira D. Hammerman

Ira D. Hammerman
Senior Managing Director and General Counsel

cc: The Honorable Christopher Cox, Chairman
The Honorable Paul S. Atkins, Commissioner
The Honorable Roel C. Campos, Commissioner
The Honorable Annette L. Nazareth, Commissioner
The Honorable Kathleen L. Casey, Commissioner

Mr. Andrew Donohue, Director, Division of Investment Management

[11] *See, e.g.*, Committee on Capital Markets Regulation, Interim Report (December 5, 2006), http://www.capmktsreg.org/pdfs/11.30Committee_Interim_ReportREV2.pdf.