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March 9, 2007

Via E-mail (rule-comments@sec.gov)

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

Re: Proposals to Adopt an Adviser Anti-Fraud Rule and Rules Raising Accredited Investor Standards for Certain Private Investment Vehicles – File No. S7-25-06

Dear Ms. Morris:

We are pleased to submit this letter in response to the Commission's request for comments on its proposals (1) to adopt a rule under the Investment Advisers Act of 1940 to prohibit advisers to pooled investment vehicles from making false or misleading statements or otherwise defrauding investors or prospective investors in those pooled investment vehicles (the "Adviser Proposal") and (2) to adopt rules under the Securities Act of 1933 to revise the definition of accredited investor, as it relates to natural persons investing in certain privately offered investment vehicles, by adding a further requirement that these persons must own not less than $2.5 million in investments (the "AI Proposal"), as contained in Release Nos. 33-8766 and IA-2576 (Dec. 27, 2006) (the "Release").

Adviser Proposal

The Commission has Not Demonstrated its Authority to Adopt the Adviser Proposal

We do not believe the Commission has adequately demonstrated its authority to adopt that portion of the Adviser Proposal which prohibits advisers from "otherwise engag[ing] 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"[1] (the "Second Prong").

Section 206(4) of the Advisers Act authorizes the Commission to "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." In adopting this provision in 1960, Congress stated:

> Because of the general language of the statutory antifraud provision and the absence of any express rulemaking power in connection with them, *it is not clear what fraudulent and deceptive activities are prohibited* by this act and as to how far the Commission is limited in this area by common-law concepts of fraud and deceit.[2] [*emphasis added*]

Congress contemplated, therefore, that the Commission's rulemaking authority would be used to articulate and deal adequately with *specific* fraudulent activities, e.g., "such problems as a material adverse interest in securities which the adviser is recommending to his clients."[3] Indeed, every one of the rules heretofore adopted under section 206(4) either has defined a particular practice as being unlawful unless specified conditions are met or has required advisers to implement specific procedures to protect against fraudulent activity.[4]

The Second Prong provides no detail as to *what* constitutes fraudulent, deceptive or manipulative conduct and verges on stating a tautology: "it shall constitute a fraudulent, deceptive, or manipulative act, practice, or course of business . . . to . . . otherwise engage in any act, practice, or course of business that is fraudulent, deceptive, or manipulative. . . ." Nor does the Commission provide in the Release any examples of the conduct it seeks to address under the Second Prong.

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1 Proposed Rule 206(4)-8(a)(2).

2 *See* S.Rep. No. 1760, 86th Cong., 2d Sess. (June 28, 1960) at 8; *see also* H.R. Rep. 2197, 86th Cong., 2d Sess. (Aug. 26, 1960) at 7.

3 *See* S.Rep. No. 1760, 86th Cong., 2d Sess. (June 28, 1960) at 8.

4 Rule 206(4)-1 (detailing advertisement content of registered advisers that has a tendency to mislead); Rule 206(4)-2 (specifying conditions pursuant to which a registered adviser may custody client funds and securities); Rule 206(4)-3 (specifying conditions pursuant to which a registered adviser may make cash payments for client solicitations); Rule 206(4)-4 (requiring registered advisers to disclose certain financial and disciplinary information to clients); Rule 206(4)-6 (requiring written policies and procedures, and disclosure to clients, in respect of proxy voting by registered advisers); and Rule 206(4)-7 (requiring registered advisers to have chief compliance officers and compliance policies and procedures).

We believe the approach the Commission takes in proposing the Second Prong stands in stark contrast to the clearly articulated purpose of each other rule adopted under section 206(4). Absent some revision of this provision and/or an adequate demonstration of the Commission's authority to adopt it, we are concerned that the Adviser Proposal might be successfully challenged. Moreover, we are at a loss to predict how the Commission and its staff may choose to utilize the Second Prong in practice, as neither the text of the rule nor the statements in the Release provide any clue whatsoever.

The Application of the Adviser Proposal to Advisers in respect of Registered Investment Companies they Advise is Unnecessary

We believe that it is unnecessary to apply the Adviser Proposal to investment advisers in respect of investment companies registered under the Investment Company Act.

All investment advisers to registered funds must register under the Advisers Act and are thereby subject to all the antifraud provisions of, and the rules adopted under, the Advisers Act. Also, as registered funds offer and sell their securities to the public, their disclosure documents – including prospectuses, statements of additional information, proxy statements and periodic shareholder reports – are themselves subject to the antifraud and remedial provisions of the Securities Act and the Securities Exchange Act, and to the substantially identical prohibition against false or misleading statements provided in section 34(b) of the Investment Company Act.[5] Moreover, the Commission has demonstrated its commitment to address fraud and alleged fraud in registered fund disclosure documents, most recently in *In the Matter of Kelmoore Investment Company*,[6] for which it appears to lack no relevant jurisdictional or procedural authority. Similarly to other aggrieved investors in publicly offered or traded securities, registered fund investors have brought many actions against registered funds and their advisers alleging material misstatements or omissions and seeking redress under, among other provisions, sections 11, 12 and 17 of the Securities Act and section 10(b) of and Rule 10b-5 under the Securities Exchange Act.

The cumulative authority of the Commission to protect investors and prospective investors in registered funds from unlawful behavior or misconduct of their

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[5] Indeed, the Commission acknowledges the similarity in the wording of section 34(b) of the Investment Company Act in respect of documents filed or transmitted pursuant to that Act, and goes so far as to state its belief that "as a general matter, most advisers that advise registered investment companies will, to a large extent, communicate with investors and prospective investors in those funds through documents that are already subject to section 34(b)." *See* Release at note 25.

[6] File No. 3-12541 (Jan. 18, 2007). The Commission found that the adviser willfully violated section 17(a)(3) of the Securities Act by engaging in a "transaction, practice or course of business [operating] as a fraud or deceit upon the purchaser," as well as section 34(b) of the Investment Company Act by making material misstatements in documents filed pursuant to that Act.

advisers is comprehensive, and the combination of Commission proceedings and civil actions brought by the Commission and aggrieved investors demonstrates vigilant and active exercise of existing authority.

We strongly urge against the creation of a needless and duplicative remedy as to which the Commission asserts there is no private right of action. The Commission does not require this provision to effectively prosecute advisers for frauds committed against investors in the registered funds they advise, and to add such a provision would only risk confusing the law and creating unforeseen collateral consequences.

The SEC Proffers No Evidence of Actual Harm to "Prospective Investors" that Never Become "Investors"

The Commission notes in the Release that sections 206(1) and (2) of the Advisers Act make unlawful fraud by advisers to both clients and *prospective clients*, and, "[f]or similar policy reasons," the Adviser Proposal also would prohibit fraudulent conduct directed towards *prospective investors* in pooled investment vehicles.[7] The Commission contends that fraudulent behavior by advisers is no less objectionable when made to prospective investors than when made to persons who have already invested in the pool.[8] We acknowledge the parallel the Commission draws between prospective clients under sections 206(1) and (2) and prospective investors under the Adviser Proposal. However, the Commission provides no examples or evidence in the public record of prospective pool investors *who never invest in the pool* actually being harmed by advisers' false or misleading statements or other frauds. Absent some demonstration of actual harm, we do not believe any final anti-fraud rule should cover prospective investors.

The Adviser Proposal Should Not Cover Without Limit the Conduct of Foreign Advisers toward their Non-U.S. Fund Clients and the Investors of those Fund Clients

The Adviser Proposal broadly covers investment advisers registered under the Advisers Act and those that are not, and its definition of "pooled investment vehicle" covers, among others, any company that is an investment company as defined in section 3(a) of the Investment Company Act. The Adviser Proposal contains no express limitations in respect of its application to non-U.S. advisers, non-U.S. pooled investment vehicles or the non-U.S. investors in these vehicles. Surely, the Commission does not anticipate blanket application of the final anti-fraud rule to all matters involving (x) advisers based outside the United States and (y) the offshore funds they manage and the investors in these funds who are resident outside the United States.

We strongly encourage the Commission to provide appropriate guidance within the final rule or the adopting release as to the intended extra-jurisdictional reach, and limits, of the rule. We suggest that such guidance proceed from the "conduct and effects" principles

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7 *See* Release at note 12 and related text.

8 *Id.*

first described by the Division of Investment Management in 1992[9] and applied thereafter in several no-action letters.[10] Under these principles, non-U.S. investment advisers would not be subject to the application of the rule so long as their activities do not constitute conduct, or have effects, within the United States. While the anti-fraud rule would apply to a non-U.S. adviser in respect of its activities within the United States or dealings with its U.S. pooled investment vehicle clients or the U.S. resident investors of those clients, it generally would not apply to the adviser's activities in respect of its non-U.S. clients or the investors in those clients.

AI Proposal

It is Inappropriate to Modify the Accredited Investor Definition for Some Investments and Not Others, Given Similar Risk Profiles and Publicly Available Information

The AI Proposal essentially changes the definition of "accredited investor" under the Securities Act, giving it one meaning for investors in the securities of "private investment vehicles" (as defined therein) and another for investors in all other privately offered securities.

As a general matter, we respectfully disagree with the Commission's approach of changing the accredited investor definition for some investments and not others. In support for distinguishing investment in certain private funds from other private investments, the Commission cites "generally" its 2003 Staff Report on the Implications of the Growth of Hedge Funds for the proposition that "private pools have become increasingly complex and involve risks not generally associated with many other issuers of securities."[11] The Release does not suggest that the Commission or its staff has conducted an analysis commensurate with its decision under the AI Proposal to distinguish investor standards for investing in certain private pools from the standards for investing in all other private offerings. We submit that many privately offered securities and their issuers share with private investment vehicles substantially identical risk profiles and similarly limited publicly available information.

Similarly, we do not believe that the Commission has offered sufficient justification for excluding investors in "venture capital funds" from the application of the accredited natural person standard. The Commission claims to "recognize the benefit that

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9 *See* U.S. Securities and Exchange Commission, Division of Investment Management, *Protecting Investors: A Half Century of Investment Company Regulation,* May 1992, p. 221-236.

10 *See*, *e.g*., Uniao de Bancos de Brasileiros S.A. (pub. avail. July 28, 1992); The National Mutual Group (pub. avail. Mar. 8, 1993); Mercury Asset Management. plc., (pub. avail. Apr. 16, 1993); Kleinwort Benson Investment Management Limited (pub. avail. Dec. 15, 1993); Royal Bank of Canada (pub. avail. June 3, 1998); and Credit Agricole Asset Management Alternative Investments, Inc. (pub. avail. Aug. 7, 2006).

11 *See* Release, note 43 and related text.

venture capital funds play in the capital formation of small businesses."[12] Yet, no evidence or analysis is provided in support of the Commission's implicit conclusion that the benefits of allowing investment in venture capital funds to proceed without the application of the accredited natural person standard outweigh any concerns that venture capital funds may present risks which do not differ in substance from those of other private investment vehicles.

We believe the current standard should be changed, if at all, only in the context of a general revisiting by the Commission of the accredited investor standard appropriate to the private offerings of all issuers. However, if the Commission will not withdraw the AI Proposal or postpone the adoption of a final rule until further evidentiary support is included in the public record, we offer more specific comments on the AI Proposal below.

In No Event Should the Rule Impede the Ability of Private Investment Vehicle Investors to Satisfy Outstanding Capital Commitments

In the Release, the Commission states that the AI Proposal would *not* grandfather current accredited investors who would not meet the new accredited natural person standard so that they could make future investments in private investment vehicles, "even those in which they currently are invested," and requests comment on this approach.

Irrespective of whether the Commission decides not to include a grandfather provision in the final rule, we strongly urge the Commission to expressly affirm that the final rule will not impede the operation or contractual arrangements of any private investment vehicle in which investors are permitted or required to make their investments in the vehicle in installments or at such times as the vehicle's manager makes capital calls to fund portfolio investments. Specifically, the Commission should make clear – in the rule itself or the release adopting the rule – that a private investment vehicle would not be required to determine whether the investor is an accredited natural person each time the investor makes additional investments in the vehicle pursuant to a binding commitment to make such payments, provided that the investor was appropriately qualified at the time the investor made the initial commitment. Such an interpretation would be entirely consistent with the Commission's interpretation in respect of section 3(c)(7) funds.[13] If an investor's initial commitment were made prior to the effective date of the final rule, the investor need only be qualified as an "ordinary" accredited investor at the time of that commitment; but if the initial commitment were made on or after the effective date, the investor would need to qualify as an accredited natural person. In both cases, however, no redetermination of investor status would be required at the time of any future capital contribution made pursuant to the original commitment.

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[12] *See* Release, note 71 and related text.

[13] *See* Privately Offered Investment Companies, Rel. No. IC-22597, section II.A.9.

A Knowledgeable Employee Exception Should be Incorporated into the AI Proposal

In the Release, the Commission requests comment on whether it should add to the list of accredited investors certain "knowledgeable employees", consistent with the concept of knowledgeable employees who are eligible, in accordance with Rule 3c-5 under the Investment Company Act, to invest in section 3(c)(1) or section 3(c)(7) funds. We support the incorporation of a "knowledgeable employee" exception substantially identical to Rule 3c-5 within the context of any final "accredited natural person" definition which the Commission may adopt. It appears self-evident to us that, if knowledgeable employees are able to invest in section 3(c)(7) funds which have a $5 million investment threshold, then they ought to be able to invest in section 3(c)(1) funds which have only a $2.5 million threshold.

The Definition of "Investments" Should Be Applied Consistently with Rule 2a51-1 to the Fullest Extent Possible

The Commission states that the definition of "investments" in the AI Proposal is based on the definition of that term set forth in Rule 2a51-1 under the Investment Company Act. The Commission notes that the proposed definition has been modified to the extent that certain provisions of Rule 2a51-1 would not be relevant to a definition that applies solely to natural persons. We fully support those modifications made to the proposed definition which eliminate particular provisions of Rule 2a51-1 that would be patently irrelevant or inapplicable to a definition of accredited natural persons.

However, we strongly encourage the Commission to make the definition of "investments" in the final accredited natural person rule as substantively consistent as possible with the definition thereof contained in Rule 2a51-1. For example, we believe it would be inappropriate for investments owned jointly by spouses to be calculated differently for qualified purchasers and accredited natural persons. We think that disparate methods of calculating joint investments could have the unintended consequence of prohibiting a prospective investor that meets the definition of qualified purchaser – and who is therefore eligible to invest in a section 3(c)(7) fund – from investing in a private investment vehicle under the new rule. This result would be contrary to the purpose stated in the Release, namely, to establish bright-line standards that maintain separate requirements for private investment vehicles and section 3(c)(7) funds.[14] We urge the Commission to include in any final rule the same treatment of joint investments as that which is included in Rule 2a51-1.

We believe the Commission should also confirm that existing interpretations of the Division of Investment Management in respect of the "investments" definition in Rule 2a51-1 apply equally to the definition of "investments" under the final accredited natural person standard. This approach should ease the burdens that private funds, their investors and counsel will face in interpreting, calculating and complying with the "investments" standard.

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[14] *See* Release, note 60 and related text.

A Venture Capital Fund Exception Based on the Definition of "Business Development Company" is Difficult to Apply and Excludes many Investment Pools commonly referred to as Venture Capital Funds

We disagree with the approach in the AI Proposal of basing the definition of "venture capital funds" excluded from the application of the accredited natural person standard on the definition of "business development companies" in the Advisers Act. We believe that the proposed exception in one sense goes too far and in another sense not far enough.

On the one hand, the proposed exception creates an essentially meaningless distinction from other private investment vehicles which, as we have discussed above, may have identical risk profiles and similarly limited publicly available information. In the face of such similarities between excepted venture capital funds and all other private investment vehicles, the Commission should demonstrate that the benefits that venture capital funds afford to small business capital formation outweigh the need to protect investors who do not meet the accredited natural person standard from the risks these funds may pose.

On the other hand, assuming that an exception for venture capital funds can be justified, we believe it is inappropriate to equate excepted venture capital funds with the Advisers Act definition of "business development companies". We think the definition of "business development companies" is complicated, and it excludes many private investment vehicles commonly perceived or classified as venture capital funds. Although business development companies might be included in a list of entities that fall within the definition of venture capital funds eligible for exclusion from the application of the accredited natural person standard, we believe that any venture capital fund definition should also be broad enough to include, among others, funds organized outside the United States and funds that may invest significantly in offshore markets or other private funds.

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We appreciate the opportunity to comment on the Proposals, and would be pleased to discuss any matters in respect of this letter. Please direct any questions or comments to John E. Baumgardner, Jr. (212-558-3866) in our New York office or Paul J. McElroy (202-956-7550) in our Washington, D.C. office.

Very truly yours,

SULLIVAN & CROMWELL LLP

cc: Andrew Donohue, Director, Division of Investment Management
Robert Plaze, Associate Director, Division of Investment Management