To: The Securities and Exchange Commission
From: Richard F. Shaffner
Date: March 9, 2007
Re: File Number S7-25-06
Commentary on the proposed rule change to:
Accredited Investors in Certain Private Investment Vehicles

Thank you for giving us the opportunity to comment on your proposed change in the accredited investor regulations.

I am a small businessman. I recently started a small hedge fund. We are expanding and growing steadily, as we build our base and demonstrate how well our investment strategies work. We have been in business less than two years, but all of our investors are satisfied, and all of them have made money with our fund. No one has wanted to withdraw their funds, and many have added to their initial investments.

In short, I have a small private investment company that is working. It is making money for me and my clients, and we are growing.

All of my investors are sophisticated enough to invest appropriately in our fund. That is a requirement that is already in place, and one that we have met. However, only one of our current investors would meet the proposed change.

If that change had been in place when I started, I would not have been able to offer this fund to these investors, and I probably would not have been able to start this private investment company. In short, this regulation would have prevented us from starting, and if passed, it might shut us down.

I suspect that this regulation works for some, politically. The large hedge funds are happy with it, because it will not affect them, and it serves as a good diversion from other issues that would affect them. It keeps the SEC focused on something else.

It also lets the SEC and politicians say they are "doing something" about hedge funds. But what they are doing would be pure politics: It would address something that is not a problem and it would fail to address many real problems that are looming for the investment industry.

Actually, it is worse than that. This change would cause far more harm that good. As support, I offer the following points:

<u>This change would not address the many hedge fund problems that need attention.</u>

To be sure, the press has carried many stories of hedge fund problems, real and potential. Among the problems mentioned are:

- The high risk taken by individual funds (mainly from derivatives and leverage)
- The risk to society and financial markets from collective positions (such as the current unwinding of the carry trade).
- A number of fraudulent activities.

These proposed changes do nothing to address any of those problems.

<u>This change would address something that isn't even a problem.</u>

I follow this business closely. I have not heard of the accredited investor definition as an issue that needs to be addressed. I suspect that somewhere in the SEC files there are some complaints from investors who lost money in hedge funds, and who say they were sold them improperly. I would also be willing to bet that one would have to look hard for those complaints, and that they are a very small fraction of the complaints that the SEC receives, especially when compared to other investments.

In short, hedge funds are a hot topic, but this is not one of their problems.

I should note that the SEC write-up for the rule also does not suggest that this is a problem. Rather, the only rationale offered is some discussion about inflation, and how the arbitrary financial hurdle set years ago is out of date.

The fact that the financial hurdle it is out of date is fortunate for all of us. It means that fewer people are harmed by the arbitrary rule that is currently in place.

<u>This change would cause more harm than good.</u>

I have heard a politician and an SEC administrator boast that, with the proposed change, they personally wanted to "make sure" that only those people that are qualified would be allowed to invest in hedge funds.

That sounds good. Of course, good regulations are not based on how they sound, but on how well they work. As stated, that "make sure" argument would not work in the real world. It is far too simplistic.

For example, the only way to make sure a patient never receives the wrong medicine is to deny him any medicine at all. The only way to keep someone from having a bad traffic accident is to not let him ride in a vehicle. The only way to keep someone from making a bad investment is to not let him invest at all. And unless you have a foolproof way of determining one's qualifications, the only way to make sure that only qualified investors invest in hedge funds is to not let anyone invest in hedge funds.

Of course, the point I am trying to make is that the SEC should never have such an absurd notion as its regulatory goal. It might work as a sound bite, but it is not the appropriate goal in the real world. I know my investors do not want it. They do not want you telling them what they cannot invest in. I bet no one does.

The goal, of course, is to try to have rules that tend to keep unqualified investors out of hedge funds, but that also let all qualified investors invest in hedge funds when they want to.

In short, the proposed regulation completely ignores the rights and opportunities of all those qualified (sophisticated) investors that the financial hurdle would keep out.

<u>The SEC already has a regulation in place to cover this point.</u>

The SEC has a regulation that says hedge funds can be sold only to people that are sophisticated enough to understand the investments risks. This proposed rule change would not affect that.

In short, if one is not qualified now, then they would not be qualified after the change, either.

However, many people that are qualified now (in all respects), would not meet the new financial test.

So, the only logical effect of the change is not that it would keep unsophisticated investors out. The current rule already does that. Rather, the only effect of the change is that it would provide an additional hurdle that would keep some otherwise qualified people out!

How would that help anyone?

<u>This change would have too high a cost, in terms of lost human rights</u>

Nowhere in your complex and highly bureaucratic 67 pages did I see any comment about the real cost of this proposed change, which would be the lost rights of those individuals that you would presume to protect. What country do you think this is? How can you consider limiting people’s rights, without considering the intrinsic harm done by that action?

We all know that we could reduce many of society’s problems by imposing more rules and regulations. We could significantly reduce lung cancer if we made tobacco illegal. We could reduce traffic fatalities dramatically if we mechanically and legally limited the top speed of all vehicles to 45 MPH. We could reduce or eliminate drunk driving and alcoholism by making alcohol illegal – or rather, we could try that again, but we should not expect it to work.

So why don't we do those things? Certainly, a regulator could argue that they would help. The answer is because our society would find each of those things to be too costly in terms of lost rights and freedoms.

<u>Too high a cost in terms of limited opportunity</u>

Many would argue that some of the most creative and best performing investment strategies are being offered in private investment companies. Why should you limit those opportunities to only those of a certain financial class? What next? Should our government say that the best medicines should only be sold to those with a certain net income or net worth? What about the best financial plans, or the best retirement strategies?

Wealthy individuals already have a significant advantage, in that they can usually pay for better services. So, now you want to make it a regulatory requirement, that investment professionals can only offer certain services to wealthy clients?

<u>A "bright line" will not work, if it is drawn in the wrong place, using the wrong criteria</u>

I understand that many regulations are important and worthwhile, and that the SEC is charged with creating and enforcing a certain portion of our society's regulations. It is a worthy goal to try to protect investors, and to make sure they have the right information before making a decision. It is also appropriate that the SEC places some burden on the seller/issuer, to make sure that he/she thinks the investment is suitable for that investor. Only good things can come from those regulations.

It is also a worthy goal to try provide regulatory clarity, to draw a "bright line" for individuals to use for following the law, and for regulators to use when enforcing it.

But, when you lack the right criteria for drawing that bright line, it would do more harm than good. The financial link to financial sophistication is tenuous. There are many people that would meet the new financial test, and should not invest in hedge funds. That would be true no matter how high you set the hurdle.

The reverse is also true! There are many people would are qualified and informed, who by all rights and logic should be allowed to invest, but whom you would deny and restrict with this new financial test.

And I finally, I would ask a simple question that, in this country, I would not think anyone would have to ask: Do you seriously think that financial status is a reasonable, constitutional, or practical basis for limiting individuals' rights?

I cannot think of any reasonable American who would want their rights limited on that basis!

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