COBB & ASSOCIATES LLC
ATTORNEYS

JEFFREY B. COBB*

GENNA DAVIES**
PAUL KELLY*
MICHAEL S. SHEEHY**

*ADMITTED IN CT AND NY
**ADMITTED IN CT AND MA

329 RIVERSIDE AVENUE
WESTPORT, CONNECTICUT 06880
TELEPHONE (203) 222-1940 FACSIMILE (203) 222-1943
www.hedgelawct.com

TWO SOUNDVIEW DRIVE, SUITE 100
GREENWICH, CONNECTICUT 06830
TELEPHONE (203) 622-7600

March 9, 2007

Via Electronic Mail and Regular Mail

Nancy M. Morris
Secretary
U.S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549-0609
Rule-comments@sec.gov

RE: 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:

We are submitting this comment letter in response to the request for comments by the Securities and Exchange Commission (the "Commission") set forth in Securities Act Release 33-8766 (the "Release") regarding (i) proposed Rule 206(4)-8 under the Investment Advisers Act of 1940, as amended (the "Advisers Act"), which would prohibit investment advisers, whether registered or unregistered, from defrauding investors in pooled investment vehicles, and (ii) proposed Rule 509 of Regulation D and proposed Rule 216 of the Securities Act of 1933, as amended (the "Securities Act"), which would define a new category of "accredited investors" that would apply solely to investors in certain private investment vehicles (Rules 509 and 216 being hereinafter referred to collectively as the "Proposed Accredited Investor Rules" or the "Proposed Rules").

We have no comments upon proposed Rule 206(4)-8 and generally support the proposal. Our comments are confined to the Proposed Accredited Investor Rules.

Summary

Our firm provides specialized legal representation to hedge funds (domestic and offshore), portfolio managers and investment advisers regarding formation and operation of hedge funds and on securities law compliance matters. Currently the firm represents over 200 funds managed by approximately 60 to 70 investment advisers. These funds range in size from approximately $5 million to over $5 billion in assets. A majority of such funds would be "private investment vehicles" within the meaning of the Proposed Accredited Investor Rules, *i.e*., funds that are relying upon the registration exception set forth in Section 3(c)(1) of the Investment Company Act of 1940, as amended (the "Investment Company Act") (herein called "Section 3(c)(1) funds").

We are seeking to provide comment based upon empirical experience and analysis of our client base and that was not generally addressed by most other commenters. Our comments include the following:

First, even assuming *arguendo* that investment sophistication is positively correlated with financial status, the data cited in the Release regarding households qualifying for accredited investor status, under existing and proposed rules, is basically flawed when applied to hedge funds, as the cited data fails to distinguish between absolute and inflationary gains and also ignores the effect of the so-called "performance fee rule"(Rule 205-3 under the Advisers Act).

Secondly, the Release, in our view, substantially overstates the complexity of the investment strategies of those funds typically available to smaller investors, the vast majority of such strategies being, in our experience, scarcely more complex than those of a typical mutual fund. We believe that hedge funds employing complex or abstruse strategies are typically only offered to "qualified purchasers", institutional investors or other classes capable of comprehending such strategies. Moreover, the availability and quality of disclosure of both simple and complex fund strategies is on the increase.

Third, on the basis of our extensive experience in representing our clients in the capital formation process, and supported by specific inquiries of certain firms as to the anticipated impact, we believe that the Proposed Accredited Investor Rules, if adopted, would substantially inhibit new fund formation, as well as impair subsequent capital raising by smaller firms, with little or no offsetting benefit to investors. In fact, as demonstrated below, the adverse impact of the Proposed Rules would deprive investors of the opportunity to invest in a particularly attractive segment of the alternative investment marketplace, as small firms offer needed diversity, innovation and, in many cases, superior investment performance as compared to larger, more mature funds.

The unwarranted and disproportionate impact of the Proposed Rules upon smaller fund managers, in our view, raises serious questions as to whether specific Congressional directives regarding the protection and fostering of small businesses are truly being met. These include certain provisions under both the Small Business Regulatory Enforcement Fairness Act of 1996 and the Regulatory Flexibility Act. While the Release addresses

certain matters under those Acts with respect to venture capital funds, as well as some analysis as to "Section 3(c)(1) pools", it fails to consider the effect of the Proposed Rules upon another class of protected "small business", namely the asset management firms to smaller funds. These managers are equally entitled to the benefits of such laws, and any rulemaking that fails to take into account the economic impact upon such firms is, we believe, fatally flawed.

Lastly, in response to the Commission's request to propose other approaches that may be more conducive to small businesses, while securing the Commission's goal of investor protection, we are proposing that the Commission consider, as alternatives, (i) increasing the net worth standard of Rule 205-3 under the Advisers Act; (ii) making Rule 505 available to private investment companies; and/or (iii) providing for a mandatory but workable disclosure document in all offerings under Regulation D.

Concurrence With Other Comments on Proposed Accredited Investor Rules

Before discussing the foregoing issues, **w**e wish to express our concurrence with the considerable adverse comment expressed by numerous other commenters (while avoiding the redundancy of repeating the related argument) regarding the Proposed Accredited Investor Rules, including, in particular, the following:

- The lack of any demonstration that the $2.5 million assets test would produce an investor class of superior sophistication as compared to the current tests.

- The fact that the Proposed Rules would single out a single class of issuers (sponsors of Section 3(c)(1) pools, but excluding venture funds) with no appreciable evidence that this is a meaningful and not arbitrary distinction.

- The fact that the assts test is needlessly complex and difficult to administer, as compared to simpler alternatives such as an increase in the present net worth test.

- The absence of any "grandfathering" of current investors, including their subsequent capital contributions.

- The absence of any provision excluding "knowledgeable employees" from accredited investor status.

Analysis of OEA Data in the Release is Arbitrary and Flawed

The Release states that according to the Commission's Office of Economic Analysis ("OEA"),

"…in 1982, when Regulation D was adopted, approximately 1.87% of U.S. households qualified for accredited investor status…by 2003 that percentage increased to

8.47% of households…by incorporating the proposed requirement [of the Proposed Rules] that percentage would decrease to 1.3% of households..” (Release, p. 24).

However, the Release fails to distinguish between changes due to absolute increases in wealth versus changes due solely to inflation. By adopting the Commission’s own argument, it could be concluded that to the extent of non-inflationary increases in wealth levels, the data merely indicates that the class of so-called financially sophisticated investors has simply increased.

Perhaps more importantly, the OEA data presumes that the income and net worth tests of Regulation D are the only financial tests applied by Section 3(c)(1) funds. Such is not the case. Rule 205-3 under the Advisers Act provides, in effect, that any registered investment adviser that charges compensation based upon a share of capital gains or appreciation must limit its clients (or investors, in the case of a pooled vehicle) to a limited number of permitted classes, the primary being a person with at least $1.5 million in net worth. Although Rule 205-3 applies only to advisers registered with the Commission, many states have adopted provisions comparable to Rule 205-3. As is commonly known, virtually all hedge fund managers charge a performance fee or allocation based upon capital appreciation. As a result, we believe that the majority of Section 3(c)(1) funds are subject to the $1.5 million net worth requirement as to their investors, and that this is the constraining test, rather than the more liberal $1 million net worth (or alternative income requirement) of Regulation D.

We note that as stated in the Release, the original $1 million net worth figure utilized in Regulation D would be $1.9 million, if indexed for inflation, by July 1, 2006 (Release, p. 23). This inflation-adjusted amount is only $400,000 in excess of the $1.5 million test effectively applicable to most fund managers under performance fee restrictions. For this reason alone, we believe that no significant change in the financial tests for accredited investor status is warranted with respect to hedge funds. As noted below, if change is warranted, we believe it is best accomplished by simply increasing the net worth requirement in Rule 205-3 from $1.5 million to $2 million.

No Meaningful Increase in Complexity of Hedge Funds Offered to Individual Investors; Increase in Availability of Information and Disclosure Standards

In perhaps the key statement in the Release, the Commission asserts

“We believe this result [reducing from 8.47% to 1.3% the number of “accredited households”] is appropriate given the increasing complexity of financial products in general, and hedge funds, in particular, over the last decade.”

However, this conclusion begs the more precise question, namely, has the complexity of hedge funds offered to the “borderline” class of individual (natural person) investors increased meaningfully? Based upon the strategies and related complexity we have observed among funds, and the relative investor bases of these funds, we would respond in the negative. Quite simply, the more complex funds, by their nature,

including generally higher capital requirements, are typically offered only to institutions or the most wealthy institutional investors. The great majority of funds offered primarily to smaller individual investors utilize fairly straightforward "long-short" (or even more simply, "long-only") investment strategies readily comprehensible to the investor.

Secondly, it is submitted that the basic risks of hedge fund investing have remained essentially unchanged since adoption of Regulation D. As Price Meadows Incorporated notes in its comment letter (dated February 16, 2007), the majority of 3(c)(1) funds are effecting investment strategies similar to those of 20 years ago, and the major risks involved are also the same as those that existed 20 years ago. Accordingly, even with increased complexity, the environment does not dictate increased "financial sophistication" to invest in such funds.

Thirdly, in analyzing the effect of assertedly greater complexity of hedge funds, the reciprocal question--namely, whether the ability of prospective investors to obtain requisite information regarding a fund investment has increased accordingly--should also be addressed. This question can clearly be answered in the affirmative. The call for greater investor transparency has been a recurrent theme in the hedge fund industry for several years. Market forces have compelled more detailed, as well as more comprehensible, disclosure of strategies, policies and risks. In a "highest common denominator" effect, the most powerful investors have demanded standards that to a considerable degree, benefit all investors. With the advent of Internet-based reporting, the proliferation of third-party databases and indices, and the broader media coverage of hedge fund databases, there should be no question that the access of even the smallest investor to fund information has significantly increased during this 20-year period.

Adoption of the Proposed Accredited Investor Rules Will Significantly Impair New Fund Formation and Capital Raising by Smaller Funds

The participation by hedge funds in the investment marketplace has been viewed as substantially beneficial. In the words of Commission Chairman Cox,

> "It is undeniable that…hedge funds also provide investors and our national securities markets with tangible benefits. They contribute substantially to capital formation, market efficiency, price discovery, and liquidity." (Testimony before U.S. Senate Banking Committee, July 23, 2006)

In particular, smaller funds play a unique role in the hedge fund industry. Without the participation of smaller funds, the industry would be heavily concentrated. For example, in a study cited by the Staff of the Commission, it was noted that the 100 largest hedge funds (of perhaps some 6,000 to 8,000 in the industry) account for slightly half the assets in the industry (Staff Report, *Implications of the Growth of Hedge Funds*, September 2003). In their special role, smaller funds (often funds in the launch or immediate post-launch phase) provide new investment approaches, diversity, increased competition and employment opportunity. In addition, it has often been observed that smaller funds (including funds in their initial growth phase) can provide significantly

better investment performance than larger funds (*see, e.g.*, Lawson and Ross, *"Small Hedge Fund Firms: Why Do They Produce Better Alpha?"*, Russell Performance Note 74 (2004)). Often the "smart money" institutional investors favor, in fact, the smaller funds over the larger ones (see, *e.g.*, Sawicki and Finn, *"Smart Money and Small Funds*", Journal of Business Finance & Accounting (June/July 2002)).

In an effort to provide some empirical data as to the impact of the Proposed Accredited Investor Rules on smaller hedge funds, this firm questioned a number of our fund manager clients with 3(c)(1) funds. Without exception, the response was that the rule change would adversely and significantly affect either, or both, of their current investor base and proposed future investors, thereby impairing their ability to raise capital. A number of firms stated that their existing investor base would be reduced by approximately 50% if the Proposed Rules were implemented.

The nature, as well as financial characteristics of investors in these early-stage or smaller funds must also be noted. Typically, the initial or early-stage investors are family members, friends, colleagues or close business associates. These are persons who, by their relationship to the fund manager, typically are afforded access to appropriate investment information and thereby qualify for the private offering exemption, quite apart from their financial status (see SEC v. Ralston Purina Co., 346 U.S. 119 (1953); SEC v. Continental Tobacco Company, 463 F. 2d 137 (Fifth Cir. 1972), *et al.*). In fact, discussion of "financial sophistication" is singularly absent from the case law interpreting the private offering exemption, and is clearly a Commission-made doctrine in the context of Regulation D. Such judicial interpretations bring into question whether it is appropriate for a financial test to become the linchpin for a "safe harbor" private offering exemption.

The Release itself states that the Proposed Rules would increase competition among 3(c)(1) funds for qualifying investment money and that such competition may lower profits among 3(c)(1) pools. As a result, 3(c)(1) fund managers may close existing funds and not launch new funds. The SEC believes these costs are justified by the potential benefit of investor protection, and possibly lower fees resulting from increased competition. We strongly disagree. We do not foresee any greater level of investor protection; moreover, the fund industry has been notoriously immune to fee competition. Most critically, we believe the Commission is greatly underestimating the potential damage to the 3(c)(1) marketplace. In fact, the Proposed Accredited Investor Rules would largely curtail the investor market for start-up funds, which, given the prohibition on general solicitations as well as business factors, depend primarily on friends, family and other closely related individuals to invest in the initial stages of fund formation.

Small businesses are also entitled by statute to special consideration and protections, including those provided by the Small Business Regulatory Enforcement Fairness Act of 1996 and the Regulatory Flexibility Act. In addition, in the Small Business Incentive Act of 1980, Congress interwove into the securities laws a variety of provisions intended to aid small businesses and promote capital formation. Although in the Release the Commission invites response as to the impact on small business, there

appears to be no clear finding, based upon any empirical study, that the requirements of these laws have been met.

In summary, based upon our own experience, discussions with clients and other inquiries, we believe that, particularly on account of their severe impact upon smaller funds and their managers, the Proposed Accredited Investor Rules will create greater inefficiencies (in terms of marketing constraints), decrease competition (by reducing the number of smaller firms in the industry) and significantly impede capital formation (by imposing unjustified investor qualifications).

Some Alternatives to the Proposed Accredited Investor Rules

We believe that it is useful to consider some possible alternatives to the Proposed Accredited Investor Rules which, in our view, would achieve more meaningful progress toward the Commission's stated goal of increased investor protection while avoiding the deficiencies and adverse effects noted by us and other commenters. These would include the following:

Increase the Net Worth Standard in Rule 205-3. In order to index the $1.5 million test in Rule 205-3 to inflation, we would suggest the Commission increase such number to $2 million. Since such standard would only apply to advisers registered with the Commission (or with states with comparable provisions) we believe that, unlike altering the accredited investor standard as proposed, this approach would provide a straightforward, workable and efficient test that should not adversely affect new fund formation or capital growth.

Make Rule 505 Available to Private Investment Companies. Regulation D currently contains a workable small offering exemption for small offerings, in the form of Rule 505. However, for technical reasons (involving Section 3(b) of the Securities Act) such Rule is not available to investment companies, including Section 3(c)(1) funds. Increasing the scope of such Rule in conjunction with the adoption of increased accredited investor standards would also, in our view, provide needed relief to smaller firms.

Provide for a Mandatory But Workable Disclosure Document in Regulation D. We believe the proper focus of the private offering exemption, consistent with case law, is the availability of relevant information to the investor. Currently, Regulation D requires a registration statement equivalent to be furnished to unaccredited investors but no specific disclosure document to accredited investors. These two extremes are, in our view anomalous and inconsistent with current market practice, which is to furnish an extensive private offering memorandum tailored to hedge funds specifically. Practice has demonstrated that a "registration statement' standard is vague, burdensome and difficult to apply in the context of a hedge fund, which has few registered counterparts. We would recommend, as an alternative, that Regulation D be amended to require the furnishing to all purchasers of an offering memorandum, containing a discussion of terms of the offering, investment strategy and policies, background of management and risk factors.

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We welcome the opportunity to comment on the Release and the Proposed Rules. Should the Commission or its Staff have any questions regarding the foregoing, kindly contact the undersigned.

Respectfully submitted,

Jeffrey Cobb