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March 14, 2007

Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549-0609
Attention: Nancy M. Morris, Secretary

Re: Proposed Rules: Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles; Accredited Investors in Certain Private Investment Vehicles

Release Nos. 33-8766; IA-2576
File No. S7-25-06

Dear Ms. Morris:

We are submitting this letter in response to Release Nos. 33-8766; IA-2576, dated December 27, 2006 (the "Proposing Release"), in which the Securities and Exchange Commission (the "Commission") has requested comments regarding its proposed Rule 206(4)-8 under the Investment Advisers Act of 1940 (the "Advisers Act") and new Rules 509 and 216 under the Securities Act of 1933, as amended (the "Securities Act").

Debevoise & Plimpton LLP is an international law firm, representing a wide range of clients around the world. Our clients include the managers and sponsors of a large number of private funds, including private equity funds and hedge funds, both domestic and offshore, that may be affected by the proposed rules. We also represent investors in private equity and hedge funds, including funds of funds, foundations and corporate and governmental retirement plans. These comments, while informed by our experience in representing these clients, represent our own views and are not intended to reflect the views of the clients of the firm.

Proposed Rule 206(4)-8[1]

Proposed Rule 206(4)-8 would make it a "fraudulent, deceptive, or manipulative act, practice, or course of business" within the meaning of Section 206(4) of the Advisers Act for an investment adviser (whether registered or unregistered) of a "pooled investment vehicle" to make any false or misleading statement of material fact or to otherwise defraud any investor or prospective investor in a pooled investment vehicle. The proposed rule applies to advisers to pooled vehicles that are registered under the Investment Company Act of 1940 (the "Investment Company Act") as well as advisers to investment pools that are not registered ("Private Funds").[2]

The purpose of the proposed Rule is to clarify, in light of last year's D.C. Court of Appeals decision in *Goldstein v. Securities and Exchange Commission* ("*Goldstein*"),[3] the Commission's ability to bring enforcement actions under the Advisers Act against investment advisers who defraud investors or prospective investors in Private Funds.

It is undoubtedly important that the Commission have all the appropriate tools to pursue its objective to "vigorously enforce the federal securities laws against managers of Private Funds who violate those laws."[4] We do not believe, however, that the proposed antifraud rule is necessary to achieve this objective. The Commission has ample

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1 We concur with the points raised in the comment letter from the Committee on Federal Regulation of Securities of the American Bar Association in their letter dated March 12, 2007 (the "ABA Comment Letter"). We also note that the Senate report on the legislation that resulted in the enactment of Section 206(4) appears to address directly Congress's intent that the Commission's rulemaking authority was designed to address specific types of fraudulent conduct involving clients rather than undefined types of conduct that did not involve clients. *See* Senate Rep. No. 1760, 86th Cong., 2d Sess. (1960), at 4, 8 ("A major concern of the bill is to aid the Commission in enforcing compliance with the act. . . . The addition of rulemaking powers to the general prohibition against fraud, *which has proved incapable of covering specific evils*, is therefore recommended by the committee. . . . The provision would enable the Commission to deal adequately with such problems as a material adverse interest in securities which the adviser is recommending to his *clients*." (emphasis added)).

2 The rule also applies to investment advisers to registered investment companies. We do not address the issues raised by this aspect of the rule in this letter; we do, however, note our concurrence with the views expressed in the ABA Comment Letter.

3 *Goldstein v. Securities and Exchange Commission*, 451 F.3d 873 (D.C. Cir. 2006).

4 Testimony Concerning Hedge Funds by Chairman Christopher Cox, U.S. Securities Exchange Commission, Before the Subcommittee on Securities and Investment of the U.S. Senate Committee on Banking, Housing and Urban Affairs (May 11, 2006).

authority to pursue violations of the federal securities laws under the existing federal securities laws, including the Advisers Act, the Securities Act of 1933 and the Securities Exchange Act of 1934.

The problems with the proposed rule extend beyond the fact that it does not appear to be necessary. We believe that the proposed rule is problematic in two significant respects: first, it does not address the *Goldstein* court's concerns with respect to the conflicts that a manager of a Private Fund (a "Private Fund Manager") would face if both the fund and the fund's investors were viewed as its clients. Second, and perhaps of greater concern, the proposed rule does not provide sufficient guidance to advisers as to the type of communications or courses of conduct that would violate the rule.

1. The Proposed Rule Creates Conflicting Duties for Private Fund Managers.

We believe that the Commission's point of departure, in considering the implications of the *Goldstein* decision, should be the Court of Appeals' decision itself. The *Goldstein* court concluded that a Private Fund Manager would be placed in an impossible position if both the private fund it managed, and the investors in the fund, would be viewed as its clients for purposes of Sections 206(1) and 206(2) of the Advisers Act:

> If the investors are owed a fiduciary duty and the entity is also faced a fiduciary duty, then the adviser will inevitably face conflicts of interest. Consider an investment adviser to a hedge fund that is about to go bankrupt. His advice to the fund will likely include any and all measures to remain solvent. His advice to the investor in the fund, however, would likely be to sell. . . . It simply cannot be the case that investment advisers are the servants of two masters in this way.[5]

There are other instances in which the interests of an individual investor may conflict, directly or indirectly, with those of the fund. The proposed rule raises the prospects of this conflict and the effort in the Proposing Release to address the point is somewhat opaque:

> Proposed rule 206(4)-8 would not create a fiduciary duty to investors or prospective investors in the pooled investment vehicle *not otherwise imposed by law*. Nor would the rule alter any duty or obligation an adviser has under the Advisers Act, any other federal law or regulation, or any

5 *Goldstein*, 451 F.2d at 881.

> state law or regulation (including state securities laws) to investors in a pooled investment vehicle it advises. (emphasis added; footnote omitted)

This statement creates the implication that whatever fiduciary duties that the Commission believed that Private Fund Managers had to Private Fund investors under Section 206 prior to the *Goldstein* decision may be imposed on Private Fund Managers by the proposed rule. The Commission should further clarify its views on this issue.

2. The Rule Does Not Adequately Describe the Conduct Prohibited.

As discussed above, the Commission has ample authority to deal with fraudulent statements made in connection with the purchase or sale of a security. Thus, if there is a need for proposed Rule 206(4)-8, it must be to address disclosures or practices that do not involve the sale of a security.[6]

By addressing statements that are not made in connection with the purchase and sale of a security, the rule will create a great deal of confusion concerning the types of statements that will fall within the scope of the rule. The Commission provides a number of examples of the types of statements that are of concern to the Commission (generally, the types of statements that might be made in connection with the sale of a security issued by the Private Fund, such as statements regarding investment strategies the Private Fund will pursue, the experience and credentials of the Private Fund Manager, or the risks associated with an investment in the Private Fund).

The proposed rule appears to apply to *any* statement made to *any* investor or prospective investor. It may often be difficult to determine if a statement was made to an investor or prospective investor, particularly if the purpose of the rule is to capture statements made outside of the context of the purchase and sale of security. Taken literally, any statement made by an adviser, even if a Private Fund managed by such investment adviser is not currently offering securities, could subject such adviser to antifraud liability because any person to whom such statement is made may be considered a prospective investor.[7]

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[6] We would hope that the Commission does not expect to use the rule to impose liability for misstatements that do not involve scienter in connection with the purchase or sale of a security. We concur with the views expressed in the ABA Comment Letter concerning the Commission's authority to adopt a non-scienter based rule.

[7] As a practical matter, this is less of an issue under Sections 206(1) and (2), which apply to misleading statements made to prospective clients. It will generally be clear, to both the adviser and a prospective client, that a statement is designed to establish a relationship with a new client.

For example, the rule may capture statements that are designed to generate investment opportunities for the Private Fund. These statements may not be misleading to the persons to whom they are directed, but may not contain all of the information that may be material to an existing or prospective investor because they are not directed at such persons. Yet, the rule raises the prospect that such statements would have to be assessed in light of what might be material to an investor or prospective investor. Subjecting such statements to antifraud liability would not only fail to serve investor protection interests, but may unnecessarily curb free communication among industry professionals.

The implications of the rule are even more uncertain with respect to other types of conduct that would be covered by the proposed rule. Section 206(4) provides the Commission with the authority to adopt rules that "define, and prescribe means reasonably designed to prevent . . . acts, practices and courses of business as are fraudulent, deceptive, or manipulative." Unlike the practices defined by the other rules adopted under Section 206(4), the practices that might be covered by the proposed rule are left undefined.

We note that the Commission has defined a number of problematic practices that warrant rules under Section 206(4). These rules are applicable only to registered investment advisers and are prophylactic in nature: they impose procedural and substantive requirements on investment advisers regardless of whether the communication or conduct is fraudulent.[8] The Commission should clarify that that the proposed rule does not, by implication or otherwise, require unregistered investment advisers to comply with the other rules adopted under Section 206(4).

Investor Accreditation Rules

The Commission proposed two rules under the Securities Act that would define a new category of accredited investor ("accredited natural person") that would apply to offers and sales of securities issued by Private Funds that rely on Section 3(c)(1) of the Investment Company Act ("3(c)(1) Funds"). An accredited natural person would be any natural person who meets either the net worth or income test specified in Rule 501(a) or Rule 215, as applicable, and who owns at least $2.5 million in investments, as defined in the proposed rule. The Proposing Release states that the proposed rules are designed to help ensure that investors in 3(c)(1) Funds are capable of evaluating and bearing the risks of their investments.

We agree that it is important that investors in private funds be limited to persons who have the requisite financial sophistication. We express no views on whether the

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8 For example, Rule 206(4)-3 imposes specific requirements on cash solicitation arrangements.

proposed threshold is appropriate. We do believe, however, that the class of natural persons to which the proposed threshold would apply is too broad and would unnecessarily preclude investment by employees of the Private Fund Manager, as well as members of the Private Fund Manager's family.

We also believe that as drafted the "non-grandfathering" of future investments by existing investors is unnecessary. Finally, we have some technical comments on the proposed rules.

1. Employee Investments.

Private Fund Managers often provide employees with the opportunity to invest in their Private Funds, either through direct or indirect investment in the private fund or through a parallel employee investment vehicle organized as a 3(c)(1) Fund. The proposed rules would have the effect of precluding Private Fund Managers from offering this important employee benefit.

We do not believe that it is necessary to impose the new threshold on employees of the Private Fund Manager. Such employees are clearly in a strong position to understand the investment strategies, risks and fee structures of 3(c)(1) Funds, particularly if they are accredited investors. The major effect of the proposed threshold would be to preclude many employees from investing in the 3(c)(1) Funds managed by their employer, thus denying them an important source of compensation. We are not aware of any abuses that suggest that this employment-related benefit should be restricted in such a significant manner.

We do not believe that the alternatives suggested in the Proposing Release, such as increased reliance on Section 4(2) or Rule 701, would provide Private Fund Managers and their employees practical relief from the new threshold. For example, Rule 701 is not a practical option for many Private Fund Managers. This is because a 3(c)(1) Fund, as with any Private Fund, generally has no employees itself. Instead, the Private Fund is managed by the general partner of the Private Fund and/or the Private Fund Manager. Because the employees of the Private Fund Manager are not employees of the Private Fund, Rule 701 would not apply to offerings of interest in the Private Fund to employees of the Private Fund Manager. While Section 4(2) may be available for offerings to employees, it is unclear to us why Private Fund Managers and their employees should be denied the benefit of the certainties provided by Regulation D.

If the Commission were to conclude that additional restrictions on employee investments were appropriate, we do not believe that there is any basis for extending them to "Knowledgeable Employees" as defined in Rule 3c-5 under the Investment Company Act. Imposing such a limitation would be contrary to Congressional intent. The Commission has acknowledged that the National Securities Markets the National Securities Markets Improvement Act of 1996 directed the Commission to prescribe rules permitting Knowledgeable Employees to invest in a Private Fund managed by their employer without causing the Private Fund to lose its exclusion from regulation under the Investment Company Act. The Commission recognized that "[t]he purpose of this provision appears to be to allow private funds to offer persons who participate in the funds' management the opportunity to invest in the fund as a benefit of employment."[9] It would be inconsistent with this intent to impose additional criteria for Knowledgeable Employee investments in 3(c)(1) Funds.[10]

2. Investments by Family Members.

As discussed above, newly-organized Private Fund Mangers often find their initial investors close to home–employees and family members. Private Fund Managers often organize separate 3(c)(1) Funds for family members and other interested investors because such individuals often are not qualified purchasers.

Many of these individuals may not qualify as "accredited natural persons." It is also not unusual, however, for a parent, spouse or sibling to come to the support of a family member who is embarking on a new venture. Therefore, we recommend that the definition of accredited natural person include family members of the principals of the Private Fund Manager as well as estate planning vehicles formed primarily to benefit such family members.

3. Suggested Rule Text.

The Commission could effect our recommendations by modifying paragraph (a) of proposed Rule 509 to read as follows:

> (a) Notwithstanding the definition of the term "accredited investor" in §230.501, in connection with the offer and sale of securities issued by an issuer that is a private investment vehicle, other than a venture capital fund, the term "accredited investor" in Regulation D (§§230.501 through 230.509) with reference to a natural person for purposes of

9 Privately Offered Investment Companies, SEC Rel. No. IC-22597 (April 3, 1997).

10 In addition, if Knowledgeable Employees are not deemed accredited natural persons, the new threshold would produce the illogical result of permitting Knowledgeable Employees to invest in 3(c)(7) funds while precluding them from investing in 3(c)(1) funds. This could have its most substantial impact on a newly-formed Private Fund Manager. The initial fund organized by such a manager will often rely on Section 3(c)(1) because many of the initial investors (friends and family) are not Qualified Purchasers. The inability to provide Knowledgeable Employees with this benefit would place such managers at a significant competitive disadvantage.

§230.501(a)(5) or §230.501(a)(6) ("accredited natural person") shall mean a natural person who meets the requirements specified in §230.501(a)(5) or §230.501(a)(6), and who **(i)** owns (individually, or jointly with that person's spouse) not less than $2.5 million in investments (as adjusted for inflation), or who the issuer reasonably believes meets such qualifications, at the time of the purchase; **(ii) is an [employee][Knowledgeable Employee (as such term is defined in §270.3a-5)] of the private investment vehicle or an Affiliated Management Person (as such term is defined in §270.3a-5) of the private investment vehicle; or (iii) is a Related Person of a controlling person of the private investment vehicle or an Affiliated Management Person of the private investment vehicle.**[11]

4. Non-Grandfathering of Existing Investors.

Proposed Rules 509 and 216 would not grandfather existing investors not meeting the "accredited natural person" standard in respect of "future investments" in private investment vehicles, including "those in which they are currently invested."[12]

The Proposing Release does not make it clear why the Commission concluded that it would be appropriate not to grandfather existing investors. For example, when Section 3(c)(7) was adopted, Congress enabled existing funds to "convert" into Section 3(c)(7) funds without requiring the fund to terminate its relationships with existing investors.[13] While the grandfathering provision does not require that the 3(c)(1) Fund expel existing investors who are not accredited natural persons, it would preclude the 3(c)(1) Fund from accepting additional investments from them.

We are not aware of any rationale for precluding an investor who has made an investment in a fund from adding to that investment. Precluding an investor from continuing to make investments in a fund with which he or she already has a relationship would place a burden primarily on the investor. The investor may have developed a financial plan that included making additional investments in the Private Fund; the proposed amendments would preclude the investor from doing so.

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11 The term "Related Person" is defined in each of the proposed rules.

12 Proposing Release, p. 25.

13 Investment Co. Release No. 22597 (Apr. 3, 197), at note 12.

If the Commission does not determine that this limitation is appropriate, the Commission should clarify that the new rule would not preclude an existing investor from fulfilling a binding commitment to make an investment that was entered into prior to the effective date of the amendments. It is common for private equity fund investors to make binding commitments to invest in the fund, which commitments are drawn upon as needed. We do not believe that funding such commitments is intended to be prohibited by the new rule. We request that the Commission clarify that satisfaction of a draw down issued by a private investment vehicle to which an investor has made a commitment is not considered a "future investment."

5. <u>Proposed Exclusion for Venture Capital Pools</u>.

We support the Commission's exclusion from proposed rules 509 and 216 certain private investment vehicles that provide capital and managerial assistance to private and other businesses.[14] We suggest certain modifications to the definition of "venture capital pool" be made to ensure that it will meet the Commission's objectives.

First, we understand that the exception is designed to recognize the important role that venture capital pools play in providing financing to United States businesses. The proposed definition, however, is tied to the definition of "business development company," which is limited to a venture capital pool organized under U.S. law and which has its principal place of business in the United States. There would appear to be no connection between the jurisdiction of the venture capital pool's organization, or its principal place of business, and the Commission's objective of assuring that the types of financing provided by venture capital pools to U.S. business are not inhibited by the new rules. Many Private Funds are organized offshore for tax or other reasons.

We therefore suggest that the definition of "venture capital pool" be modified as follows:

> Venture capital fund has the same meaning as "business development company" in section 202(a)(22) of the Investment Advisers Act of 1940 (15 U.S.C. 80b-2(a)(22)) **provided that the venture capital fund need not be organized under the laws of, or have its principal place of business in, any State or States**.

6. <u>Joint Investments</u>.

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14 Proposing Release, pp. 30-32.

The Commission based the proposed definition of "investments" in the proposed rules on the definition of that term set forth in Rule 2a51-1 under the Investment Company Act. We support the Commission's approach.

However, the Commission concluded that it would be appropriate to make an exception to this approach with respect to attributing investments that are jointly owned by a prospective investor to the investor in determining whether the investor is an accredited natural person. The proposed rules would provide that a person acting as an individual, and not in conjunction with a spouse, should only be permitted to count only fifty percent of (a) investments jointly held with his or her spouse and (b) any investments in which the person shares a communal property or similar shared ownership interest with his or her spouse.

We do not believe there is a justification for this change. The Commission also does not explain how attributing fifty percent of the value of property held jointly with a spouse or shared as community property more accurately reflects an individual's financial experience or sophistication. More importantly, however, it would create a needless distinction between the approach in the new rules and that taken under Section 3(c)(7)–an approach familiar to Private Fund Managers. While Private Fund sponsors that offer 3(c)(1) Funds would have to revise their investor qualification questionnaires in any event to determine whether a prospective investor is an accredited natural person, the burden would be greater to the extent that different methodologies apply to determining accredited natural person status as opposed to qualified purchaser status.

We urge the Commission to implement the approach it has taken elsewhere and allow a natural person investing individually to include any assets owned jointly with such person's spouse in determining the amount of such person's investments.

Transition Period for the Rule Proposals

The Proposing Release does not suggest a transition period for proposed Rules 509 and 216. Advisers to private investment vehicles that are affected by these rules will need to revise the offering and subscription documentation for such private investment vehicles as a result of these rules. In some instances, an adviser to a private investment vehicle may no longer be able to operate such vehicle as a result of the rules and will need to plan for the orderly liquidation of such vehicle. We would propose a minimum transition period of one year for proposed Rules 509 and 216.

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We appreciate the opportunity to comment on the proposed rule and would be pleased to answer any questions you might have regarding our comments. Please contact Kenneth J. Berman at (202) 383-8050, Michael P. Harrell at (212) 909-6349 or Marcia L. MacHarg at +49 69 20 97 5120.

Respectfully submitted,

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cc: