



# Federal Register

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Part III

## Securities and Exchange Commission

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17 CFR Parts 230 and 275

**Prohibition of Fraud by Advisers to  
Certain Pooled Investment Vehicles;  
Accredited Investors in Certain Private  
Investment Vehicles; Proposed Rule**

## SECURITIES AND EXCHANGE COMMISSION

### 17 CFR Parts 230 and 275

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

RIN 3235-AJ67

#### Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles; Accredited Investors in Certain Private Investment Vehicles

**AGENCY:** Securities and Exchange Commission.

**ACTION:** Proposed rule.

**SUMMARY:** The Commission is today proposing new rules designed to provide additional investor protections that would affect pooled investment vehicles, including hedge funds. First, the Commission is proposing a rule that would prohibit advisers to pooled investment vehicles from making false or misleading statements or otherwise defrauding investors or prospective investors in those pooled investment vehicles. Second, the Commission is proposing two rules that would revise the definition of accredited investor as it relates to natural persons. The latter rules would apply solely to the offer and sale of interests in certain privately offered investment pools specified in the rules.

**DATES:** Comments should be received on or before March 9, 2007.

**ADDRESSES:** Comments may be submitted by any of the following methods:

#### Electronic Comments

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/proposed.shtml>); or
- Send an e-mail to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File Number S7-25-06 on the subject line; or
- Use the Federal eRulemaking Portal (<http://www.regulations.gov>). Follow the instructions for submitting comments.

#### Paper Comments

- Send paper comments in triplicate to Nancy M. Morris, Secretary, Securities and Exchange Commission, 100 F Street, NE., Washington, DC 20549-1090.

All submissions should refer to File Number S7-25-06. This file number should be included on the subject line if e-mail is used. To help us process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site

(<http://www.sec.gov/rules/proposed.shtml>). Comments are also available for public inspection and copying in the Commission's Public Reference Room, 100 F Street, NE., Washington, DC 20549. All comments received will be posted without change; we do not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly.

#### FOR FURTHER INFORMATION CONTACT:

With respect to proposed rule 206(4)-8, Jennifer Sawin, Senior Special Counsel, or Daniel Kahl, Branch Chief, at 202-551-6787, and with respect to proposed rules 216 and 509, Elizabeth G. Osterman, Assistant Chief Counsel, or Tara R. Buckley, Senior Counsel, at 202-551-6825, Division of Investment Management, Securities and Exchange Commission, 100 F Street, NE., Washington, DC 20549-5041.

**SUPPLEMENTARY INFORMATION:** The Commission is requesting comment on proposed new rule 206(4)-8 under the Investment Advisers Act of 1940 ("Advisers Act"),<sup>1</sup> and proposed new rules 216 and 509 under the Securities Act of 1933 ("Securities Act").<sup>2</sup>

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<sup>1</sup> 15 U.S.C. 80b. Unless otherwise noted, when we refer to the Advisers Act, or any paragraph of the Advisers Act, we are referring to 15 U.S.C. 80b of the United States Code, at which the Advisers Act is codified.

<sup>2</sup> 15 U.S.C. 77. Unless otherwise noted, when we refer to the Securities Act, or any paragraph of the Securities Act, we are referring to 15 U.S.C. 77 of the United States Code, at which the Securities Act is codified.

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#### I. Introduction

In the past few years, the Commission has been examining a variety of issues relating to hedge funds and other pooled investment vehicles with a view to strengthening protections for investors.<sup>3</sup> We are now proposing to address two areas of particular concern. First, we are proposing to adopt a new antifraud rule under the Advisers Act that would clarify, in light of a recent court decision,<sup>4</sup> the Commission's ability to bring enforcement actions under the Advisers Act against investment advisers who defraud investors or prospective investors in a hedge fund or other pooled investment vehicle.

Second, we are proposing a rule that would revise the requirements for determining whether an individual is eligible to invest in certain pooled investment vehicles. We are concerned that the definition of "accredited investor," which certain privately offered investment pools ("private pools") use in determining whether an individual is eligible to invest in the pool, may not provide sufficient protections for investors. We are therefore proposing to define a new category of accredited investor called "accredited natural person," which is designed to help ensure that investors in these types of funds are capable of evaluating and bearing the risks of their investments.

Consistent with the purposes of the Advisers Act and the Securities Act, we believe these two proposals have the potential to enhance substantially the protections for investors and potential investors in hedge funds and other similar funds.

#### II. Antifraud Provisions of the Advisers Act

The Advisers Act is intended to protect investors whose assets are managed by investment advisers in pools as well as those who rely on advisers to manage their individual portfolios or to otherwise provide them with investment advice.<sup>5</sup> Advisers to

<sup>3</sup> See, e.g., *Implications of the Growth of Hedge Funds, Staff Report to the United States Securities and Exchange Commission*, available at <http://www.sec.gov/spotlight/hedgefunds.htm> ("2003 Staff Study").

<sup>4</sup> *Goldstein v. Securities and Exchange Commission*, 451 F.3d 873 (D.C. Cir. 2006) ("Goldstein").

<sup>5</sup> Section 201 (Findings) of the Advisers Act states "that investment advisers are of national concern,

pooled investment vehicles that invest in securities, including unregistered pools, are "investment advisers" under the Advisers Act.<sup>6</sup>

The Advisers Act gives the Commission broad authority to protect against fraud by these investment advisers. Section 206(1) of the Advisers Act makes it unlawful for any adviser to "employ any device, scheme, or artifice to defraud any client or prospective client," and section 206(2) makes it unlawful for any adviser to "engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client." Section 206(4) of the Advisers Act provides that it is unlawful for investment advisers to "engage in any act, practice, or course of business which is fraudulent, deceptive, or manipulative" and that "[t]he Commission shall, for purposes of [paragraph 206(4)] 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."<sup>7</sup>

in that, among other things . . . the foregoing transactions occur in such volume as substantially to affect interstate commerce, national securities exchanges, and other securities markets, the national banking system, and the national economy."

<sup>6</sup> Section 202(a)(11) of the Advisers Act defines an investment adviser as "any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities \* \* \*". Sections 202(a)(11)(A)-(F) identify several types of persons who are excepted from this definition, even though they may give advice about securities; exceptions are available to certain banks, accountants, lawyers, teachers, engineers, broker-dealers, publishers and ratings agencies. See also *Abrahamson v. Fleschner*, 568 F.2d 862, 871 (2d Cir. 1977), cert. denied, 436 U.S. 913 (1978), overruled on other grounds by *Transamerica Mortgage Advisors, Inc. v. Lewis*, 444 U.S. 11 (1979) ("Transamerica"); *SEC v. Saltzman*, 127 F. Supp. 2d 660, 669 (E.D. Pa. 2000); *SEC v. Michael W. Berger, Manhattan Investment Fund, Ltd., and Manhattan Capital Management, Inc.*, 244 F. Supp. 2d 180, 192 (S.D.N.Y. 2001).

<sup>7</sup> Section 206(4) was added to the Advisers Act in Pub. L. No. 86-750, 74 Stat. 885 (1960) at sec. 9. See H.R. Rep. No. 2197, 86th Cong., 2d Sess. (1960) at 7-8 ("Because of the general language of section 206 and the absence of express rulemaking power in that section, there has always been a question as to the scope of the fraudulent and deceptive activities which are prohibited and the extent to which the Commission is limited in this area by common law concepts of fraud and deceit \* \* \* [Section 206(4)] would empower the Commission, by rules and regulations to define, and prescribe means reasonably designed to prevent, acts, practices, and courses of business which are fraudulent, deceptive, or manipulative. This is comparable to Section 15(c)(2) of the Securities Exchange Act of 1934 [15 U.S.C. 78o(c)(2)] which applies to brokers and dealers."). See also S. Rep. No. 1760, 86th Cong., 2d Sess. (1960) at 8 ("This

Recently, an opinion by the Court of Appeals for the DC Circuit created uncertainties regarding obligations that investment advisers to pools have to the pools' investors.<sup>8</sup> The court, in *Goldstein v. SEC*, vacated a rule we adopted in 2004 that required certain hedge fund advisers to register under the Advisers Act.<sup>9</sup> In addressing the scope of the exemption from registration in section 203(b)(3) of the Advisers Act and the meaning of "client" as used in that section, the court expressed the view that, for purposes of sections 206(1) and (2), the "client" of an investment adviser managing a pool is the pool itself, not the investors in the pool.<sup>10</sup> As a result, the opinion created some uncertainty regarding the application of sections 206(1) and 206(2) of the Advisers Act in certain cases where investors in a pool are defrauded by an investment adviser.

The *Goldstein* decision did not, however, call into question the Commission's authority to adopt rules under section 206(4) of the Advisers Act to protect investors in pooled investment vehicles. Section 206(4) is broader in scope and not limited to conduct aimed at clients or prospective clients. This section permits us to adopt rules proscribing fraudulent conduct that is potentially harmful to the growing number of investors who directly or indirectly invest in hedge funds and other types of pooled investment vehicles. Our commitment to protect the interests of those investors

[section 206(4) language] is almost the identical wording of section 15(c)(2) of the Securities Exchange Act of 1934 in regard to brokers and dealers."). The Supreme Court, in *United States v. O'Hagan*, interpreted nearly identical language in section 14(e) of the Securities Exchange Act of 1934 [15 U.S.C. 78n(e)] ("Exchange Act") as providing the Commission with authority to adopt rules that are "definitional and prophylactic" and that may prohibit acts that are "not themselves fraudulent \* \* \* if the prohibition is 'reasonably designed to prevent \* \* \* acts and practices [that] are fraudulent.'" *United States v. O'Hagan*, 521 U.S. 642, at 667, 673 (1997). The wording of the rulemaking authority in section 206(4) remains substantially similar to that of section 14(e) and section 15(c)(2) of the Exchange Act.

<sup>8</sup> Prior to the issuance of this opinion, we brought enforcement actions against hedge fund advisers alleging false or misleading statements to investors under sections 206(1) and (2) of the Advisers Act. See, e.g., *SEC v. Kirk S. Wright, International Management Associates, LLC, et al.*, Litigation Release No. 19581 (Feb. 28, 2006); *SEC v. Wood River Capital Management, LLC, et al.*, Litigation Release No. 19428 (Oct. 13, 2005) ("Wood River"); *SEC v. Samuel Israel III; Daniel E. Marino; Bayou Management, LLC; Bayou Accredited Fund, LLC; Bayou Affiliates Fund, LLC; Bayou No Leverage Fund, LLC; and Bayou Superfund, LLC*, Litigation Release No. 19406 (Sept. 29, 2005) ("Bayou"); *SEC v. Beacon Hill Asset Management LLC, et al.*, Litigation Release No. 18745A (June 16, 2004).

<sup>9</sup> *Goldstein, supra* note 4.

<sup>10</sup> *Id.*

is no less than those to whom the adviser directly provides investment advice.

Accordingly, today we are using our authority under section 206(4) to propose, as a means reasonably designed to prevent fraud, a new rule under the Advisers Act that would prohibit advisers to investment companies and other pooled investment vehicles from (i) making false or misleading statements to investors in those pools, or (ii) otherwise defrauding them. We would enforce the rule through administrative and civil actions against advisers under section 206(4) of the Advisers Act.

#### A. Scope of Proposed Rule 206(4)-8

##### 1. Investors and Prospective Investors

Section 206(4), unlike sections 206(1) and (2), is not limited to conduct aimed at clients or prospective clients.<sup>11</sup> Proposed rule 206(4)-8 would address the uncertainty created by the *Goldstein* decision regarding conduct aimed at investors by prohibiting advisers from (i) making false or misleading statements to investors in pooled investment vehicles, or (ii) otherwise defrauding these investors.

Sections 206(1) and (2) of the Act make unlawful fraud by advisers to both clients and *prospective* clients. For similar policy reasons, rule 206(4)-8 would also prohibit false or misleading statements made to, or other fraud on, prospective investors in pooled investment vehicles.<sup>12</sup> Thus, the rule would prohibit false or misleading statements made, for example, to existing investors in account statements as well as to prospective investors in private placement memoranda, offering circulars, or responses to "requests for proposals."

We request comment on this aspect of the proposed rule.

##### 2. Unregistered Advisers

The proposed rule would apply to any investment adviser to a pooled investment vehicle, including advisers that are not registered or required to be registered under the Advisers Act.<sup>13</sup>

<sup>11</sup> See *Goldstein, supra* note 4, at note 6. See also *United States v. Elliott*, 62 F.3d 1304, 1311 (11th Cir. 1995).

<sup>12</sup> The effect of "prospective clients" in section 206(1) and (2) is to make unlawful fraudulent behavior that an adviser uses in an attempt to draw in new clients. Similarly, we are including "prospective investors" in the proposed rule for the same underlying policy reasons—that false or misleading statements and other frauds by advisers are no less objectionable when made to prospective investors than when made to persons who have already invested in the pool.

<sup>13</sup> Proposed rule 206(4)-8 does not address the question of whether a person is an investment

Many of our enforcement cases against advisers to pools have been against advisers that are not registered under the Advisers Act, and we believe it is critical that we continue to be in a position to bring actions against unregistered advisers that manage pools and that defraud investors in those pools.

While section 206 applies to all investment advisers,<sup>14</sup> our other antifraud rules adopted under section 206 apply only to advisers registered or required to be registered under the Advisers Act.<sup>15</sup> In 1996, Congress enacted the National Securities Markets Improvements Act ("NSMIA"), which delegated to state securities authorities responsibility for regulating smaller advisers (which would no longer register with us).<sup>16</sup> Although Congress intended that we continue to apply our general antifraud authority under section 206 to state-registered advisers,<sup>17</sup> we decided not to apply the prophylactic provisions of our rules under section 206(4) to advisers not registered (or required to be registered) with us because we concluded that these matters had become more appropriately issues for state regulators. Accordingly, in 1997, we amended the rules we had adopted under section 206(4) to limit their application to advisers registered or required to be registered with us,<sup>18</sup> and our more recently adopted rules under section

adviser and thus subject to the Act, including the antifraud provisions.

<sup>14</sup> See, e.g., *SEC v. K.L. Group, LLC, et al.*, Litigation Release No. 19117 (Mar. 3, 2005) ("KL Group"); *SEC v. Barry Alan Bingham and Bingham Capital Management*, Litigation Release No. 19345 (Aug. 23, 2005); *SEC v. Conrad P. Seghers and James R. Dickey*, Litigation Release No. 18749 (June 17, 2004); *SEC v. Ryan J. Fontaine and Simpleton Holdings Corporation a/k/a Signature Investments Hedge Fund*, Litigation Release No. 17864 (Nov. 26, 2002); *SEC v. Edward Thomas Jung, et al.*, Litigation Release No. 17417 (Mar. 15, 2002).

<sup>15</sup> See rules 206(4)–1 through 7 under the Advisers Act [17 CFR 275.206(4)–1 through 7].

<sup>16</sup> Pub. L. No. 104–290, 110 Stat. 3416 (1996) (codified in scattered sections of the U.S. Code). NSMIA generally allocated regulatory authority to state securities authorities for advisers that did not manage a registered investment company and that had less than \$25 million of assets under management. Section 203A of the Advisers Act prohibits these smaller advisers from registering with the Commission.

<sup>17</sup> See S. Rep. No. 293, 104th Cong., 2d Sess. 3–4 (1996) ("1996 Senate Report") at 4 ("Both the Commission and the states will be able to continue bringing antifraud actions against investment advisers regardless of whether the investment adviser is registered with the state or the SEC."). The Commission has brought such actions against state-registered advisers. See, e.g., *In the Matter of James William Fuller*, Investment Advisers Act Release No. 1842 (Oct. 4, 1999).

<sup>18</sup> See *Rules Implementing Amendments to the Investment Advisers Act of 1940*, Investment Advisers Act Release No. 1633 (May 15, 1997) [62 FR 28112 (May 22, 1997)].

206(4) have also been limited in scope to advisers registered or required to be registered with us.<sup>19</sup> We believe, however, that it may be appropriate to apply proposed rule 206(4)–8 to all investment advisers because the rule is designed broadly to define the making of materially false or misleading statements as a fraudulent, deceptive or manipulative practice, and to prohibit other practices that defraud or deceive pool investors, rather than designed to prohibit a specific practice.

We request comment on this aspect of the proposed rule. Commenters who believe certain advisers to pools should not be subject to the rule should please explain in detail which advisers should be exempt, and why such an exemption would be appropriate.

### 3. Pooled Investment Vehicles

The proposed rule would not distinguish among types of pooled investment vehicles and is designed to protect investors both in investment companies and in pools that are excluded from the definition of investment company under section 3(a) of the Investment Company Act of 1940 ("Company Act")<sup>20</sup> by reason of either section 3(c)(1) or 3(c)(7) of the Company Act.<sup>21</sup> We believe that most of the pooled investment vehicles privately offered to investors are organized under one or the other of these two provisions.

Like section 206, the new antifraud rule would apply to all advisers regardless of the investment strategy they employ, or the structure of the type of pooled investment vehicle they

<sup>19</sup> See *Proxy Voting by Investment Advisers*, Investment Advisers Act Release No. 2106 (Jan. 31, 2003) [68 FR 6585 (Feb. 7, 2003)]; *Compliance Programs of Investment Companies and Investment Advisers*, Investment Advisers Act Release No. 2204 (Dec. 17, 2003) [68 FR 74713 (Dec. 24, 2003)].

<sup>20</sup> 15 U.S.C. 80a. Unless otherwise noted, when we refer to the Company Act, or any paragraph of the Company Act, we are referring to 15 U.S.C. 80a of the United States Code, at which the Company Act is codified.

<sup>21</sup> Company Act section 3(c)(1) or (7). Section 3(c)(1) excludes from the definition of investment company an issuer the securities (other than short-term paper) of which are beneficially owned by not more than 100 persons and that is not making or proposing to make a public offering of its securities. Section 3(c)(7) excludes from the definition of investment company an issuer the outstanding securities of which are owned exclusively by persons who, at the time of acquisition of such securities, are "qualified purchasers" and that is not making or proposing to make a public offering of its securities. "Qualified purchaser" is defined in section 2(a)(51) of the Company Act generally to include a natural person (or a company owned by two or more related natural persons) who owns not less than \$5,000,000 in investments; a person, acting for his own account or accounts of other qualified purchasers, who owns and invests on a discretionary basis, not less than \$25,000,000; and a trust whose trustee, and each of its settlors, is a qualified purchaser.

manage. As a result, the rule would apply to investment advisers subject to section 206 of the Advisers Act with respect to all pooled investment vehicles that they advise, such as hedge funds, private equity funds, venture capital funds, and other types of privately offered pools that invest in securities, as well as investment companies that are offered to the public.<sup>22</sup> Defrauding investors in any of these pools is equally unacceptable.

We request comment on the scope of the proposed rule. We are proposing to include only investment companies and companies that qualify for the exclusions provided by sections 3(c)(1) and 3(c)(7) of the Company Act, but request comment on whether the rule should apply to companies excluded from the definition of investment company by other provisions in section 3(c) of the Company Act. Commenters suggesting we broaden the scope of the proposed rule should please indicate which types of companies should be included and why. Conversely, commenters favoring limiting the application of the rule so as to exclude certain pools, as we are proposing to do in the Securities Act rules we propose in this Release,<sup>23</sup> should please explain to us how we should draw distinctions among pools in this regard, and why those distinctions are appropriate.

### B. Prohibition on False or Misleading Statements

Under proposed rule 206(4)–8(a)(1), it would constitute a fraudulent, deceptive, or manipulative act, practice, or course of business within the meaning of section 206(4) for any investment adviser to a pooled investment vehicle to make any untrue statement of a material fact to any investor or prospective investor in the pooled investment vehicle, or to omit to state a material fact necessary in order to make the statements made to any investor or prospective investor in the pooled investment vehicle, in the light of the circumstances under which they were made, not misleading.<sup>24</sup> This wording, which is similar to that in many of our antifraud laws and rules,<sup>25</sup>

<sup>22</sup> We have brought enforcement actions under the Advisers Act against advisers to these types of funds. See, e.g., *In the Matter of Thayer Capital Partners, et al.*, Investment Advisers Act Release No. 2276 (Aug. 12, 2004) (private equity fund); *SEC v. Michael A. Liberty, et al.*, Litigation Release No. 19601 (Mar. 8, 2006) (venture capital fund); *In the Matter of Askin Capital Management, L.P. and David J. Askin*, Investment Advisers Act Release No. 1492 (May 23, 1995).

<sup>23</sup> See Section III.B.4 of this Release.

<sup>24</sup> Proposed rule 206(4)–8(a)(1).

<sup>25</sup> See, e.g., sections 12 and 17 of the Securities Act; section 14 of the Exchange Act [15 U.S.C. 78n];

prohibits false or misleading statements of material facts by investment advisers.

Unlike rule 10b-5 under the Exchange Act and other rules that focus on securities transactions, rule 206(4)-8 would not be limited to fraud in connection with the purchase and sale of a security.<sup>26</sup> Accordingly, proposed rule 206(4)-8(a)(1) would prohibit advisers to pooled investment vehicles from making any materially false or misleading statements to investors in the pool regardless of whether the pool is offering, selling, or redeeming securities. Unlike violations of rule 10b-5, the Commission would not need to demonstrate that an adviser violating rule 206(4)-8 acted with scienter.<sup>27</sup> There would be no private cause of action against an adviser under the proposed rule.<sup>28</sup>

section 34 of the Company Act; rules 156, 159, and 610 under the Securities Act [17 CFR 230.156, 230.159, 230.610]; rules 10b-5, 13e-3, 13e-4, and 15c1-2 under the Exchange Act [17 CFR 240.10b-5, 240.13e-3, 240.13e-4, 240.15c1-2]; and rule 17j-1 under the Company Act [17 CFR 270.17j-1]. In addition, section 34(b) of the Company Act uses similar wording with respect to documents filed or transmitted pursuant to the Company Act; we believe 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).

<sup>26</sup> Under the proposed rule, we could bring enforcement actions even when the facts of the case did not involve the offer, purchase or sale of a security. We have, however, brought a number of enforcement actions involving pools alleging violations of section 10(b) of the Exchange Act [15 U.S.C. 78j(b)], rule 10b-5 under the Exchange Act [17 CFR 240.10b-5], and section 17(a) of the Securities Act, when the alleged frauds were “in connection with the purchase or sale of a security,” or allegedly involved the “offer or sale” of a security. See, e.g., *SEC v. Sharon E. Vaughn and Directors Financial Group, Ltd.*, Litigation Release No. 19589 (Mar. 3, 2006); *SEC v. HMC International, LLC., et al.*, Litigation Release No. 19508 (Dec. 21, 2005); *In the Matter of Maxwell Investments, LLC, Gary J. Maxwell, and Bart D. Coon*, Investment Advisers Act Release No. 2455 (Dec. 1, 2005); *Wood River*, supra note 8; *Bayou*, supra note 8; *SEC v. Jon E. Hankins, et al.*, Litigation Release No. 19283 (June 24, 2005).

<sup>27</sup> See *SEC v. Steadman*, 967 F.2d 636, at 647 (D.C. Cir. 1992). The court in *Steadman* analogized section 206(4) of the Advisers Act to section 17(a)(3) of the Securities Act, which the Supreme Court had held did not require a finding of scienter, *id.* (citing *Aaron v. SEC*, 446 U.S. 680 (1980)); the *Steadman* court concluded that “scienter is not required under section 206(4).” *Id.* In discussing section 17(a)(3) and its lack of a scienter requirement, the *Steadman* court observed that, similarly, a violation of section 206(2) of the Advisers Act could rest on a finding of simple negligence. *Id.* at 643 note 5. For the same reason, the Commission would not need to demonstrate scienter under paragraph (a)(2) of the proposed rule. See Section II.C of this Release for a discussion of paragraph (a)(2).

<sup>28</sup> The Supreme Court has held that “there exists a limited private remedy under the Investment Advisers Act of 1940 to void an investment adviser’s contract, but that the Act confers no other private causes of action, legal or equitable.” *Transamerica*, supra note 6, at 24 (footnote

The effect of this provision of the rule would be to prohibit, for example, materially false or misleading statements regarding investment strategies the pooled investment vehicle will pursue (including strategies the adviser may pursue for the pool in the future), the experience and credentials of the adviser (or its associated persons), the risks associated with an investment in the pool, the performance of the pool or other funds advised by the adviser, the valuation of the pool or investor accounts in it, and practices the adviser follows in the operation of its advisory business such as how the adviser allocates investment opportunities.<sup>29</sup>

We request comment on these provisions of the proposed rule.

### C. Prohibition of Other Frauds

We are also using our broad authority under section 206(4) to propose a prohibition against other fraud on investors in pooled investment vehicles by advisers to those pools. Proposed rule 206(4)-8(a)(2) would make it a fraudulent, deceptive, or manipulative act, practice, or course of business for any investment adviser to a pooled investment vehicle to “otherwise engage 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.”<sup>30</sup> The language of this provision is drawn from the first sentence of section 206(4) and is designed to apply more broadly to deceptive conduct that may not involve statements.

We request comment on this provision.

omitted). Similarly, paragraph (a)(2) of the proposed rule would not create a new private right of action. See Section II.C of this Release for a discussion of paragraph (a)(2).

<sup>29</sup> We have previously brought enforcement actions alleging these or similar types of frauds. We have brought actions alleging advisers’ material misrepresentations or omissions regarding their background or experience. See, e.g., *SEC v. EPG Global Private Equity Fund*, Litigation Release No. 18577 (Feb. 17, 2004); *SEC v. Peter W. Chabot, Chabot Investments, Inc., Sirens Investments, Inc., Sirens Synergy, The Synergy Fund, LLC*, Litigation Release No. 18214 (July 3, 2003); *SEC v. Ashbury Capital Partners, L.P., Ashbury Capital Management, L.L.C., and Mark Yagalla*, Litigation Release No. 16770 (Oct. 17, 2000); *SEC v. Michael Batterman, Randall B. Batterman III, and Dynasty Fund, Ltd., et al.*, Litigation Release No. 16615 (June 30, 2000). We have also brought enforcement actions alleging advisers’ misrepresentations of the pool’s performance. See, e.g., *In the Matter of Evan Misshula*, Investment Advisers Act Release No. 2524 (June 21, 2006); *Bayou*, supra note 8; *K.L. Group*, supra note 14; *In the Matter of Samer M. El Bizri and Bizri Capital Partners, Inc.*, Investment Advisers Act Release No. 2250 (June 16, 2004).

<sup>30</sup> Proposed rule 206(4)-8(a)(2).

### D. No Fiduciary Duty Created

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 state law or regulation (including state securities laws) to investors in a pooled investment vehicle it advises.<sup>31</sup>

## III. Amendments to Private Offering Rules Under the Securities Act

### A. Offer and Sale of Securities Issued by Private Investment Pools

Private offerings of securities issued by investment pools in the United States are made without compliance with the registration and prospectus delivery requirements of section 5 of the Securities Act<sup>32</sup> in reliance on the private offering exemption provided by section 4(2) of the Securities Act or in compliance with certain rules related to that section.

Section 4(2) exempts from the registration requirements of the Securities Act any “transaction by an issuer not involving a public offering.”<sup>33</sup> Before 1982, our rules generally required an issuer seeking to rely on section 4(2) to make a subjective determination that each offeree had sufficient knowledge and experience in financial and business matters to enable that offeree to evaluate the merits of the prospective investment or that such offeree was able to bear the economic risk of the investment.

In part because of a degree of uncertainty as to the availability of the

<sup>31</sup> For example, under the Uniform Limited Partnership Act, advisers who serve as general partners owe fiduciary duties to the limited partners. Unif. Limited Partnership Act § 408 (2001).

<sup>32</sup> Section 5 of the Securities Act requires that the offer and sale of an issuer’s securities comply with certain registration requirements, unless an exemption from registration is available for that transaction or class of securities.

<sup>33</sup> In 1980, Congress enacted section 4(6) of the Securities Act to provide an additional offering exemption. Small Business Investment Incentive Act of 1980, Pub. L. 96-477, § 602 (Oct. 21, 1980) (codified at 15 U.S.C. 77d(6)). Section 4(6) provides an issuer exemption for offers and sales of securities to accredited investors if the issuer offers no more than \$5 million of securities and does not engage in a general solicitation. At the same time, Congress enacted section 2(a)(15) of the Securities Act. Section 2(a)(15)(i) establishes a statutory definition of the term “accredited investor” used in section 4(6) that includes certain institutions. Section 2(a)(15)(ii) provides the Commission with statutory authority to adopt rules to further define any person (including any natural person) as an accredited investor based on “such factors as financial sophistication, net worth, knowledge, and experience in financial matters, or amount of assets under management.”

section 4(2) exemption,<sup>34</sup> the Commission adopted Regulation D under the Securities Act in 1982 to establish non-exclusive “safe harbor” criteria for the section 4(2) private offering exemption.<sup>35</sup> Rule 506 of Regulation D is the safe harbor protection that privately offered investment pools typically rely upon in making offers and sales of their securities.<sup>36</sup> An issuer may sell its securities under rule 506 to an unlimited number of “accredited investors”<sup>37</sup> without registration under the Securities Act, unless the issuer is subject to another restriction.<sup>38</sup>

<sup>34</sup> In 1953, in discussing the private offering exemption, the U.S. Supreme Court stated that a private offering is an “offering to those who are shown to be able to fend for themselves” and that the availability of the private offering exemption “turns on the knowledge of the offerees” and is limited to situations in which the offerees have access to the kind of information afforded by registration under section 5 of the Securities Act. *SEC v. Ralston Purina Co.*, 346 U.S. 119, 125, 126–27 (1953).

<sup>35</sup> Securities Act Release No. 6389 (Mar. 8, 1982) [47 FR 11251 (Mar. 16, 1982)] (adopting Regulation D) (“1982 Adopting Release”). Rule 501(a) of Regulation D applies to offerings made under rules 505 and 506 of Regulation D and defines accredited investor to include a number of categories of investors.

As noted, section 4(6) of the Securities Act also provides an exemption for certain offers and sales made to accredited investors. *See supra* note 33. The definition of accredited investor for purposes of section 4(6) is contained partly in section 2(a)(15)(i) of the Securities Act and partly in rule 215 under that Act. Rule 215 contains the categories of accredited investors adopted by the Commission. Taken together, the accredited investor categories under section 4(6) are the same as under Regulation D. *See* Defining the Term “Qualified Purchaser” under the Securities Act of 1933, Securities Act Release No. 8041 (Dec. 19, 2001) [66 FR 66839 (Dec. 27, 2001)] (“2001 Proposing Release”) (history of accredited investor concept).

<sup>36</sup> Most private pools rely on an exclusion from the definition of investment company under the Company Act provided by section 3(c)(1) or section 3(c)(7) of the Company Act, both of which are premised on the absence of a public offering. *See supra* note 21 (generally discusses such exclusions); 2003 Staff Study, *supra* note 3 (staff discussion of exclusions and related interpretation of private offering).

<sup>37</sup> An issuer making a private offering under rule 506 also may have 35 non-accredited purchasers of its securities provided that each such purchaser has such knowledge and experience in financial and business matters that the purchaser is capable of evaluating the merits and risks of the prospective investment, or the issuer reasonably believes immediately prior to making any sale that such purchaser comes within this description. *See* rule 506(b)(2). Such non-accredited investors must receive certain disclosure required by Regulation D. *See* rule 502(b). Section 4(6), section 2(a)(15) and rule 215 do not include this provision.

<sup>38</sup> *See* Company Act section 3(c)(1), *supra* note 21. Private pools that rely on the exclusion from the definition of investment company provided by section 3(c)(1) of the Company Act (“3(c)(1) Pools”) may have no more than 100 beneficial owners, regardless of whether they are accredited investors under rule 501(a). In addition, issuers with more than 499 holders of record generally must register their securities under the Exchange Act. *See*

Rule 501(a) of Regulation D defines the term “accredited investor” to include a natural person whose individual net worth, or joint net worth with the person’s spouse, exceeds \$1,000,000 at the time of the purchase,<sup>39</sup> or whose individual income exceeds \$200,000 (or joint income with the person’s spouse exceeds \$300,000) in each of the two most recent years and who has a reasonable expectation of reaching the same income level in the year of investment.<sup>40</sup> We adopted the \$1,000,000 net worth and \$200,000 income standards in 1982 based on our view that these tests would provide appropriate and objective standards to meet our goal of ensuring that only such persons who are capable of evaluating the merits and risks of an investment in private offerings may invest in one.<sup>41</sup>

We recently have taken the opportunity to reconsider the standards we established to qualify persons as accredited investors under the safe harbor provided under Regulation D and our rules for certain small offerings. We note our staff’s observation in its 2003 Staff Study that “inflation, along with the sustained growth in wealth and income of the 1990s, has boosted a substantial number of investors past the ‘accredited investor’ standard.”<sup>42</sup> Based on analysis conducted by our Office of Economic Analysis (“OEA”), we also note that the increase in investor wealth is due in part to the increase in the values of personal residences since 1982. Accordingly, many individual investors today may be eligible to make investments in privately offered investment pools as accredited investors that previously may not have qualified as such for those investments.

Moreover, private pools have become increasingly complex and involve risks not generally associated with many other issuers of securities.<sup>43</sup> Not only do private pools often use complicated investment strategies, but there is minimal information available about them in the public domain. Accordingly, investors may not have access to the kind of information provided through our system of securities registration and therefore may find it difficult to appreciate the unique risks of these pools, including those

Exchange Act section 12 [15 U.S.C. 78j] and rule 12g-1 [17 CFR 240.12g-1] under the Exchange Act.

<sup>39</sup> Rule 501(a)(5).

<sup>40</sup> Rule 501(a)(6).

<sup>41</sup> 1982 Adopting Release, *supra* note 35. *See also* Securities Act Release No. 6758 (Mar. 3, 1988) [53 FR 7866 (Mar. 10, 1988)] (adopting \$300,000 joint income standard).

<sup>42</sup> 2003 Staff Study, *supra* note 3 at text accompanying note 271.

<sup>43</sup> *See generally* 2003 Staff Study, *id.*

with respect to undisclosed conflicts of interest, complex fee structures and the higher risk that may accompany such pools’ anticipated returns.

We note that natural persons may have indirect exposure to private pools as a result of their participation in pension plans and investment in certain pooled investment vehicles that invest in private pools. Such plans and vehicles are generally administered by entities of plan fiduciaries and registered investment professionals. This protection is not present in the case of natural persons who seek to invest in 3(c)(1) Pools outside of the structure of such pension plans and pooled investment vehicles. Moreover, while the existing net worth and income tests provide some investor protection, we believe that additional protections may be appropriate.

The investor protections that we believe may be lacking with respect to 3(c)(1) Pools already exist for private pools that rely on the exclusion from the definition of investment company provided by section 3(c)(7) of the Company Act (“3(c)(7) Pools”).<sup>44</sup> Natural persons who invest in such pools are required to own \$5 million in certain investments at the time of their investment in the pool.<sup>45</sup> In addition, for a 3(c)(7) Pool to rely on the safe harbor provided by Regulation D, the pool must limit the sale of its securities to qualified purchasers who also meet the definition of accredited investor. Accordingly, 3(c)(7) Pools are subject to a two-step approach that is designed to provide assurance that an investor has a level of knowledge and financial sophistication and the ability to bear the economic risk of the investment in such pools, as demonstrated by the investor’s investment experience and also, for natural persons, that person’s net worth or income.

We believe that such a two-step approach may provide important, additional investor protections to natural persons who invest in certain 3(c)(1) Pools. Accordingly, as discussed below, the proposed rules governing investments in such pools incorporate that approach.

<sup>44</sup> *See supra* note 21.

<sup>45</sup> Company Act section 2(a)(51)(A). *See also* note 21 (definition of “qualified purchaser” as it relates to natural persons). *See* 1996 Senate Report, *supra* note 17 at 10 (“The qualified purchaser pool reflects the Committee’s recognition that financially sophisticated investors are in a position to appreciate the risks associated with investment pools that do not have the Investment Company Act’s protections. Generally, these investors can evaluate on their own behalf matters such as the level of a fund’s management fees, governance provisions, transactions with affiliates, investment risk, leverage, and redemptions rights.”).

### B. Proposed Rules 509 and 216

For the reasons discussed above, we are proposing two rules under the Securities Act. As proposed, rules 509 and 216 would define a new category of accredited investor (“accredited natural person”) that would apply to offers and sales of securities issued by certain 3(c)(1) Pools (defined in the proposed rules as “private investment vehicles”) to accredited investors under Regulation D and section 4(6).<sup>46</sup> The term accredited natural person would mean 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 rules. The term would apply for purposes of ascertaining whether a person is an accredited investor at the time of that person’s purchase of securities of private investment vehicles. As proposed, the rules would not alter the criteria for investments by natural persons described in rule 501(a)(4) and rule 215(d).

Rule 501(a) generally provides that the term “accredited investor” means a person who is or who the issuer reasonably believes comes within any of the categories specified in the rule. Proposed rule 509(a) incorporates this concept. We note that a similar provision is not included under section 4(6), section 2(a)(15) or rule 215,<sup>47</sup> and therefore proposed rule 216 does not incorporate this concept. We solicit comments on this approach.

Except as modified by the application of the proposed definition of accredited natural person, all other provisions of Regulation D, and sections 4(6) and 2(a)(15) and rule 215, would continue to apply to the offer and sale of securities issued by private investment vehicles. The application of the proposed rules and the definitions used in the proposed rules are discussed more fully below.

#### 1. Application of Proposed Rules to Private Investment Vehicles

The proposed rules would apply solely to the offer and sale of securities issued by private investment vehicles, as defined in the proposed rules.<sup>48</sup> The proposed rules would not apply to offers and sales of securities issued by private funds not meeting the proposed definition of the term private investment vehicle, including venture

capital funds, as defined in the proposed rules and discussed below.<sup>49</sup>

The proposed rules would define the term private investment vehicle to mean an issuer that would be an investment company (as defined in section 3(a) of the Company Act) but for the exclusion provided by section 3(c)(1) of that Act.<sup>50</sup> The proposed rules would apply to private investment vehicles that rely on the safe harbor provisions of Regulation D in connection with the offer and sale of their securities. The proposed rules would also apply to offerings of private investment vehicles made in reliance on section 4(6) of the Securities Act.

We are not including 3(c)(7) Pools within the definition of private investment vehicle because offers and sales of securities issued by 3(c)(7) Pools must be made to qualified purchasers (as that term is defined by section 2(a)(51)(A) of the Company Act) who are also accredited investors under Regulation D. As noted, 3(c)(7) Pools already are subject to investor protections with higher thresholds than the ones that we propose today.<sup>51</sup> Commenters who suggest that we increase the net worth and income amounts specified under Regulation D for natural persons in response to comments solicited below in connection with the proposed definition of accredited natural person, however, are asked to comment on whether, if we adopt such an approach, the net worth and income amounts specified under Regulation D for natural persons should also be increased for 3(c)(7) Pools.

#### 2. Definition of Accredited Natural Person

As proposed, the term accredited natural person would include any natural person who meets the requirements specified in the current definition of accredited person, as that term relates to natural persons,<sup>52</sup> and would add a requirement that such person also must own (individually, or jointly with the person’s spouse) not less than \$2.5 million (as adjusted every five years for inflation<sup>53</sup>) in investments at the time of purchase of securities issued by private investment vehicles under Regulation D or section 4(6).<sup>54</sup> The proposed rules would not alter the criteria for investments by natural

persons described in rule 501(a)(4) and rule 215(d). The proposed definition is similar in design to the two-step approach for 3(c)(7) Pools.<sup>55</sup> The proposed definition is consistent with our goal of providing an objective and clear standard to use in ascertaining whether a purchaser of a private investment vehicle’s securities is likely to have sufficient knowledge and experience in financial and business matters to enable that purchaser to evaluate the merits and risks of a prospective investment, or to hire someone who can.

We also are proposing to amend paragraphs (a)(5) and (a)(6) of rule 501 and paragraphs (e) and (f) of rule 215 to provide a cross-reference to our proposed definition of accredited natural person in proposed rule 509 and proposed rule 216, as applicable. Such a cross-reference would alert persons reading rules 501 and 215 to the existence of the proposed rules for sales of securities issued by private investment vehicles.

We solicit comment on whether retaining the existing definition of accredited investor as it relates to natural persons and adding an additional requirement for that term that uses the amount and type of a natural person’s investments (individually, or jointly with the person’s spouse) is an appropriate standard by which to measure whether that person is likely to have sufficient knowledge and financial sophistication to evaluate the merits of a prospective investment in a private investment vehicle and to bear the economic risk of such an investment.

Solely in the context of investments in private investment vehicles, if we adopt rules using the two-step approach that we propose today, commenters are asked whether we should increase (or decrease) the amounts specified for the net worth and income criteria applicable to natural persons under the Regulation D definition of accredited investor. Commenters are also solicited for their views on whether (and why) we should use a standard based *solely* on the objective net worth and income tests specified in the existing rules under Regulation D and rule 215 for offers and sales of securities issued by private investment vehicles to natural persons, rather than adding the proposed additional criteria based on investments.<sup>56</sup> In responding to both or either of these requests, we ask commenters to discuss what they

<sup>46</sup> Our proposed definition would be the same for purposes of section 4(6) and Regulation D private offerings. Accordingly, except as noted, we do not discuss the rules separately.

<sup>47</sup> See *supra* note 37.

<sup>48</sup> Proposed rule 509(a); proposed rule 216(a).

<sup>49</sup> See *infra* section III.B.4.

<sup>50</sup> Proposed rule 509(b)(1); proposed rule 216(b)(1).

<sup>51</sup> See *supra* notes 44 and 45 and accompanying text.

<sup>52</sup> See section 2(a)(15) and rules 215 and 501(a).

<sup>53</sup> Proposed rule 509(c)(6); proposed rule 216(c)(6).

<sup>54</sup> See discussion of the terms private investment vehicle and investments elsewhere in this release.

<sup>55</sup> See *supra* notes 44 and 45 and accompanying text.

<sup>56</sup> See *supra* notes 39 and 40 and accompanying text.



believe the appropriate levels for the net worth and income criteria should be, if different than set forth in our accredited investor rules. For example, OEA estimates that the levels used in those rules, adjusted for inflation, would have been approximately \$1.9 million (net worth), \$388,000 (individual income) and \$582,000 (joint income) as of July 1, 2006.<sup>57</sup> Commenters who believe that changing the applicable levels under either the proposed two-step approach or the current definition are requested to suggest alternate levels and to explain why it would be appropriate to use the suggested approach and changed levels. We also request that commenters explain in their response why their suggestions would address our interest in providing an objective and clear standard for ascertaining whether a purchaser of a private investment vehicle's securities is likely to have sufficient knowledge and financial sophistication to enable that purchaser to evaluate the merits of a prospective investment in a private investment vehicle and to bear the economic risk of such an investment.

We have specified \$2.5 million for the amount of investments that a person would be required to own under the proposed definition. As proposed, this dollar amount would be adjusted for inflation on April 1, 2012, and every five years thereafter, to reflect any changes in the value of the Personal Consumption Expenditures Chain-Type Price Index (or any successor index thereto), as published by the Department of Commerce, from December 31, 2006.<sup>58</sup> OEA estimates that approximately 1.3% of United States households would qualify for accredited natural person status based on owning \$2.5 million in investments.<sup>59</sup> It estimates that in 1982, when Regulation D was adopted, approximately 1.87% of U.S. households qualified for accredited

investor status. It further estimates that by 2003 that percentage increased by 350% to approximately 8.47% of households. By incorporating the proposed requirement for \$2.5 million of investments owned by the natural person at the time of purchase, that percentage would decrease to 1.3% of households that would qualify for accredited natural person status, a percentage below 1982 levels. We believe that this result is appropriate given the increasing complexity of financial products, in general, and hedge funds, in particular, over the last decade. In addition, we note that the proposed level is less than required for qualified purchasers in 3(c)(7) Pools. We believe that the proposed amount therefore would establish a bright-line standard that addresses our concerns about the increase in individual wealth and income, but that maintains separate requirements for private investment vehicles, 3(c)(7) Pools and investments in all other private offerings.<sup>60</sup> We generally solicit comment on this approach.

In particular, commenters are asked to comment on our proposal to adjust the amount every five years and the methodology that we have used for this purpose in the proposed rules. Should the time period between adjustments be longer or shorter than five years? Is the methodology (calculation based on the proposed index and time period) used in the proposed rules appropriate? Commenters responding to these questions who believe that a different methodology and/or time period would be appropriate for us to use are asked to provide rule text for their suggestion. They also are asked to explain why their suggestion would be more appropriate. We also request commenters' views on our data. Is there a more appropriate data set to use that would support another amount or is there a more appropriate way to interpret the data that we used?

We also solicit comment on our proposal to use \$2.5 million as the level of investments that an accredited natural person must own. Should we use another level that is higher or lower than proposed? For example, as discussed previously, natural persons seeking to invest in 3(c)(7) Pools must own \$5 million in investments at the time of purchase. Also, investment advisers may charge a natural person client a performance fee if the adviser reasonably believes that the client has a net worth (together with assets held jointly with the client's spouse) of more than \$1.5 million at the time that the

client enters into a contract with the adviser.<sup>61</sup> Is one of these levels more appropriate than the proposed \$2.5 million? Commenters responding to this request who believe that a different amount would be more appropriate are asked to specify that amount and explain why they believe that it is a more appropriate measure of a natural person's investment experience, financial knowledge and sophistication. Such commenters are asked to suggest rule text reflecting their view.

We note that our proposed rules 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 pools, even those in which they currently are invested. Commenters are asked to comment on whether such a grandfathering provision is necessary and/or appropriate and why.

We also solicit comment on whether employees of private investment vehicles or their investment advisers (collectively "pool employees") should be subject to the same accredited natural person standard. Would applying such a standard to pool employees preclude many of them from investing in such pools? We are aware that many private investment vehicles currently offer and sell their interests to pool employees who do not meet the current accredited investor standard. We note that such private investment vehicles may: (i) Rely on rule 506, which allows for 35 non-accredited purchasers, provided that the pool employees meet the condition in rule 506(b)(2)(ii) and receive the information required by rule 502(b); (ii) make an offering pursuant to section 4(2) of the Securities Act; or (iii) rely on rule 701 under the Securities Act, which provides an exemption from registration for offers and sales of securities to certain natural persons pursuant to certain compensatory benefit plans and contracts relating to compensation. We also are aware that many private pools provide equity incentive compensation to pool employees through contractual arrangements in employment agreements not subject to direct regulation under the federal securities laws. For example, a private pool manager may allocate a portion of the pool's interest in the performance fee, or "carry," payable by the pool, to certain

<sup>57</sup> OEA estimated these levels using the Personal Consumption Expenditures Chain-Type Price Index, as published by the Department of Commerce, available at <http://www.bea.gov>.

<sup>58</sup> Each adjustment would be rounded to the nearest multiple of \$100,000.

We have selected the above-referenced index following discussions with the Federal Reserve Bank and our conclusion that that index is a widely used and broad indicator of inflation in the U.S. economy.

<sup>59</sup> This estimate was prepared by OEA using data from the 1983 and 2004 Federal Reserve Surveys of Consumer Finance ("Federal Reserve Surveys"). The Federal Reserve Survey is conducted triennially. The 1983 and 2004 Federal Reserve Surveys used year-end 1982 and 2003 values, respectively. More information regarding the Federal Reserve Surveys may be obtained at <http://www.federalreserve.gov/pubs/oss/oss2/scfindex.html>.

<sup>60</sup> See *supra* note 21.

<sup>61</sup> See rule 205-3(a) and (d)(1)(i)(A) (performance fee prohibition of the Advisers Act does not apply to qualified clients, defined to include a natural person with more than \$1.5 million of net worth (together with assets held jointly with the person's spouse) at the time that the natural person enters into a contract with the adviser).



of its employees. We request comment on whether any or all of the four different ways that we believe that private pools may compensate pool employees are sufficient to permit pool employees who are not accredited natural persons to receive securities issued by a private investment vehicle. Commenters who believe that they are not are asked to explain why not. We also request comment on whether we should add to the list of accredited natural persons certain “knowledgeable employees,” consistent with the concept of “knowledgeable employees” eligible to invest in private investment pools in accordance with rule 3c-5 under the Company Act.<sup>62</sup>

### 3. Definition of Investments

We have based the proposed definition of investments in the proposed rules on the definition of that term set forth in rule 2a51-1 under the Company Act.<sup>63</sup> Including this definition would provide a bright-line standard for ascertaining an investor’s status as an accredited natural person.

We have modified the proposed definition of investments to the extent that certain provisions of rule 2a51-1 would not be relevant to a definition that applies solely to natural persons. For example, rule 2a51-1 generally refers to qualified purchaser<sup>64</sup> and section 3(c)(7) Pools. These terms generally are not relevant to the definition of accredited natural person because the proposed definition relates only to natural persons and would not involve investments in 3(c)(7) Pools. We solicit comment on whether we have made appropriate modifications to the term investments for purposes of the proposed definition. If not, commenters are asked to discuss any changes that they believe would be appropriate and why they believe that they would be appropriate.

In addition, the treatment in the proposed rules of investments a natural person may own jointly with a spouse or that are part of a shared community interest is different from the treatment of such investments under rule 2a51-1.

Rule 2a51-1 permits all of such investments to be included in the determination of whether a natural person is a qualified purchaser for purposes of section 2(a)(51)(A).<sup>65</sup> We believe that, for purposes of determining whether a natural person, acting on that person’s own behalf (and not jointly with a spouse), should be able to qualify as an accredited natural person, a natural person’s investments should include only a portion of the amount of any investments owned jointly, or of any investments which ownership is shared, with the person’s spouse. Accordingly, the proposed rules provide that the investments of a natural person seeking to make an investment in a private investment vehicle on his or her own behalf may include only 50 percent of: (a) Any of such person’s investments held jointly with that person’s spouse; and (b) any investments in which the natural person shares a community property or similar shared ownership interest with that person’s spouse.<sup>66</sup> We believe that including only half of these categories of investments is typical of the division of assets of natural persons and their spouses made for other purposes. Where spouses make a joint investment in a private investment vehicle, the full amount of all of their investments (whether made jointly or separately) may be included for purposes of determining whether each spouse is an accredited natural person. We seek comment on this amount and the approach generally, including the feasibility of implementing it. In addition, the proposed rules would provide that the aggregate amount of investments owned and invested on a discretionary basis by the natural person is the fair market value of such investments.<sup>67</sup> We intend the value of a natural person’s investments to be calculated on a per investment basis. We solicit comment on whether this is clear.

As noted previously, one reason for the rise in the net worth of natural persons is the increase in the value of personal residences since 1982. We believe that such an increase should not be relevant in evaluating whether an investor may qualify as an accredited investor for purposes of sales under Regulation D or section 4(6) of securities issued by private investment vehicles. Moreover, the value of a person’s personal residence or place of business, or real estate held in connection with a

trade or business, bears little or no relationship to that person’s knowledge and financial sophistication. Accordingly, the proposed definition, like rule 2a51-1 on which it is modeled, would not include, as an investment held for investment purposes, real estate that is used by a natural person or certain family members for personal purposes or as a place of business, or in connection with a trade or business.<sup>68</sup> Is this treatment of real estate appropriate? Commenters who respond to this question are asked to discuss whether they believe that any such real estate should be counted as an investment held for investment purposes under the proposed rules and why. We solicit comment on our concern about the effect of increased housing values on the application of the definition of accredited investor solely in connection with the offer and sale of private investment companies.

We solicit comment on whether our proposed definition of investments captures the universe of relevant investments that should be included for purposes of the proposed definition. Should any investments included in our proposed definition be excluded? Are there any investments that are not reflected in our definition that should be included? Commenters are asked to explain the basis for any exclusion or inclusion that they recommend.

Our proposed definition of “prospective accredited natural person” refers to securities “issued by” a private investment vehicle rather than the reference to securities “of” a 3(c)(7) Pool under the parallel definition in rule 2a51-1 under the Company Act. The use of securities “of” an issuer could be misinterpreted to refer to the portfolio securities held by a private pool and not the securities issued by that pool. Rule 2a51-1 was not meant to be subject to such an interpretation and neither are our proposed rules.

### 4. Proposed Exclusion for Venture Capital Pools

The proposed rules specifically would not apply to the offer and sale of securities issued by venture capital funds. As defined in the proposed rules, the term venture capital fund would have the same meaning as the definition of business development company in section 202(a)(22) of the Advisers Act.<sup>69</sup>

<sup>68</sup> Proposed rule 509(c)(1)(i); proposed rule 216(c)(1)(i).

<sup>69</sup> Proposed rule 509(b)(2); proposed rule 216(b)(2). See section 202(a)(22) of the Advisers Act. Section 202(a)(22) defines the term business development company to mean any company which is described in section 2(a)(48) of the

<sup>62</sup> Under rule 3c-5, knowledgeable employees include executive officers, directors, trustees, general partners and advisory board members of a 3(c)(1) Pool or a 3(c)(7) Pool, and those who serve in similar capacities. The rule also includes certain other employees of the private fund or its management affiliate who participate in investment activities and have performed such functions for at least 12 months.

<sup>63</sup> Proposed rule 509(b)(3); proposed rule 216(b)(3).

<sup>64</sup> The term “qualified purchaser” includes both institutional investors and natural persons that meet the conditions of section 2(a)(51)(A) of the Company Act.

<sup>65</sup> Rule 2a51-1(g)(2).

<sup>66</sup> Proposed rule 509(c)(4); proposed rule 216(c)(4).

<sup>67</sup> Proposed rule 509(c)(2); proposed rule 216(c)(2).

In the Small Business Investment Incentive Act of 1980, Congress generally modeled the definition of business development company on the capital formation activities of venture capital funds.<sup>70</sup> Both venture capital funds and business development companies provide capital to small businesses. They also often provide managerial assistance to these small businesses.<sup>71</sup> In proposing to exclude the offer and sale of securities issued by venture capital funds from the application of the proposed definition, therefore, we recognize the benefit that venture capital funds play in the capital formation of small businesses.

We note that the term business development company is also defined in section 2(a)(48) of the Company Act.<sup>72</sup>

Company Act, *infra* note 72, and which complies with section 55 of the Company Act, except that, in contrast to business development companies under the Company Act, a business development company under the Advisers Act: (i) is prohibited from acquiring any assets (except those described by section 55(a)(1) through (7) of the Company Act which include securities issued by “eligible portfolio companies”) unless at least 60 percent of its total assets are invested in assets described by 55(a)(1) through (6) (for purposes of this release “section 55(a) assets”) (compared to 70 percent for Company Act business development companies); (ii) does not have to be a closed-end company or be subject to the provisions of sections 55 through 65 of the Company Act; and (iii) may purchase section 55(a) assets from any person. A business development company defined in section 202(a)(22) must offer managerial assistance to companies that are counted against its 60 percent requirement.

The Company Act generally defines eligible portfolio companies to be domestic companies that are not (i) investment companies or (ii) companies that would be investment companies but for the exclusions provided by section 3(c) of the Company Act. Company Act sections 2(a)(46)(A) and (B). *See generally Definition of Eligible Portfolio Company under the Investment Company Act of 1940*, Company Act Release No. 27538 (Oct. 25, 2006) [71 FR 64086 (Oct. 31, 2006)] (adoption of new definition of the term eligible portfolio company). *See also Definition of Eligible Portfolio Company under the Investment Company Act of 1940*, Company Act Release No. 27539 (Oct. 25, 2006) [71 FR 64093 (Oct. 31, 2006)] (proposal to include additional domestic, non-financial companies within the definition of the term eligible portfolio company).

<sup>70</sup> See H.R. Rep. No. 1341, 96th Cong., 2d Sess. 21 (1980) (“1980 House Report”).

<sup>71</sup> See *id.* at 21.

<sup>72</sup> See section 2(a)(48) of the Company Act. Section 2(a)(48) defines business development company for purposes of the Company Act as any closed-end company which securities are registered under the Securities Act and: (i) is organized under the laws of, and has its principal place of business in, any State or States; (ii) is operated for the purpose of making investments in section 55(a) assets, *see supra* note 69, (iii) is prohibited from making any purchases of any assets (except those described by section 55(a)(1) through (7) of the Company Act) unless the value of the company’s assets invested in section 55(a) assets at the time of any new purchase constitutes at least 70 percent of the value of its total assets; (iv) offers managerial assistance to issuers of section 55(a) assets that it purchases; and (v) has elected to be subject to the provisions of sections 55 through 65 of the

We solicit comment on whether defining venture capital fund with reference to the definition provided in the Advisers Act is appropriate. Would it be more appropriate to define venture capital fund with reference to the definition provided in the Company Act? Would it be more appropriate to define venture capital funds in terms of their investment objective and strategy (e.g., investing in and developing start-up and early phase businesses)? Alternatively, would it be more appropriate to define private investment vehicles to be 3(c)(1) Pools that do not permit their investors to redeem their interests in the pools within a specified period of time (“holding period”)?<sup>73</sup> Would such an approach cause most 3(c)(1) Pools to simply extend their holding periods sufficient to avoid application of the proposed rules? We request comment on how this would affect investors, including those with respect to any possible adverse effect on investors that might result from such extension of holding periods. For example, how would taking such an approach impact natural persons who might have more current needs for assets invested in the pool? If we followed this approach, should we also include a provision that would allow private investment vehicles to redeem securities in the case of emergencies, such as the death or serious illness of an investor, or other unforeseeable events?<sup>74</sup> If we adopted this approach, would two years be appropriate,<sup>75</sup> or would a shorter (e.g., one year) or longer (e.g., four year) holding period be more appropriate?

We particularly solicit the views of commenters on the different types of investments made by venture capital funds, as currently operating in the market, and business development companies, as defined under the Advisers Act.<sup>76</sup> We note that there currently are venture capital funds that

invest significantly in offshore markets or other private pools. If we were to adopt a definition of venture capital fund based on either of the statutory definitions of business development company, should we modify that definition to include venture capital funds that invest a significant amount of their assets in foreign securities and other private pools?

We request comment on whether excluding venture capital funds from the application of the proposed rules is appropriate at all. If so, would applying the proposed definition to them affect their ability to raise capital? Are there other policy reasons for excluding venture capital funds? For example, are there aspects of such funds that make them more appropriate investments for less wealthy investors?

**IV. General Request for Comment**

The Commission requests comment on the rules proposed in this Release, suggestions for additions to the rules, whether any changes are necessary or appropriate to implement the objectives of our proposed rules and what those changes might be, and comment on other matters that might have an effect on the proposals contained in this Release. For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996, the Commission also requests information regarding the potential impact of the proposed rules on the economy on an annual basis. Commenters should provide empirical data to support their views.

#### IV. General Request for Comment

**V. Paperwork Reduction Act**

*A. Proposed Rule 206(4)–8*

The proposed rule, titled 206(4)–8 Pooled Investment Vehicles, would not impose a new “collection of information” within the meaning of the Paperwork Reduction Act of 1995.<sup>77</sup> Proposed rule 206(4)–8 would make it a fraudulent, deceptive, or manipulative act, practice, or course of business for an investment adviser to a pooled investment vehicle to make any untrue statement of material fact or to omit to state a material fact necessary in order to make the statements made not misleading to any investor or prospective investor in the pooled investment vehicle. The proposed rule would also make it a fraudulent, deceptive or manipulative act, practice, or course of business within the meaning of section 206(4) for any investment adviser to certain pooled investment vehicles to otherwise engage in any act, practice, or course of

Company Act. In addition, Company Act business development companies are generally required to purchase section 55(a) assets from their issuers or close affiliates.

<sup>73</sup> See, e.g., *Registration Under the Advisers Act of Certain Hedge Fund Advisers*, Investment Advisers Act Release No. 2333 (Dec. 2, 2004) [69 FR 72054 (Dec. 10, 2004)] (generally defined “private fund” to mean any “company: (i) That would be an investment company under section 3(a) of the \* \* \* Company Act but for the [exclusion] provided from that definition by either section 3(c)(1) or 3(c)(7) of [the Company] Act \* \* \*”; (ii) That permits its owners to redeem any portion of their ownership interests within two years of the purchase of such interests; and (iii) Interests in which are or have been offered based on the investment advisory skills, ability or expertise of the investment adviser.”).

<sup>74</sup> *Id.*

<sup>75</sup> *Id.*

<sup>76</sup> See *supra* note 69.

<sup>77</sup> 44 U.S.C. 3501 to 3520.

business that is fraudulent, deceptive, or manipulative with respect to any investor or prospective investor in the pooled investment vehicle. The proposed rule would not create any filing, reporting, recordkeeping, or disclosure requirements for investment advisers subject to the rule and accordingly there would be no "collection of information" under the Paperwork Reduction Act.

#### B. Proposed Rules 509 and 216

Certain provisions of proposed rules 509 and 216 contain "collection of information" requirements within the meaning of the Paperwork Reduction Act of 1995 [44 U.S.C. 3501 *et seq.*], and the Commission is submitting the proposed collection of information to the Office of Management and Budget ("OMB") for review in accordance with 44 U.S.C. 3507(d) and 5 CFR 1320.11. The title for the collection of information is "Form D." An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid OMB control number.

Form D (OMB Control No. 3235-0076) was adopted pursuant to sections 2(a)(15), 3(b), 4(2), 19(a) and 19(c)(3) of the Securities Act [15 U.S.C. 77b(15), 77c(b), 77d(2), 77s(a) and 77s(c)(3)].

We recently have taken the opportunity to reconsider the standards we established to qualify persons as accredited investors under the safe harbor provided under Regulation D and our rules for certain small offerings. We note our staff's observation in its 2003 Staff Study that "inflation, along with the sustained growth in wealth and income of the 1990s, has boosted a substantial number of investors past the 'accredited investor' standard."<sup>78</sup> Based on analysis conducted by OEA, we also note that the increase in investor wealth is due in part to the increase in the values of personal residences since 1982. Accordingly, many individual investors today may be eligible to make investments in privately offered investment pools as accredited investors that previously may not have qualified as such for those investments. Moreover, private pools have become increasingly complex and involve risks not generally associated with many other issuers of securities.<sup>79</sup> Not only do private pools often use complicated investment strategies, but there is minimal information available about them in the public domain.

<sup>78</sup> 2003 Staff Study, *supra* note 3 at text accompanying note 271.

<sup>79</sup> See generally 2003 Staff Study, *id.*

Accordingly, investors may not have access to the kind of information provided through our system of securities registration and therefore may find it difficult to appreciate the unique risks of these pools, including those with respect to undisclosed conflicts of interest, complex fee structures and the higher risk that may accompany such pools' anticipated returns.

We note that natural persons may have indirect exposure to private pools as a result of their participation in pension plans and investment in certain pooled investment vehicles that invest in private pools. Such plans and vehicles are generally administered by entities of plan fiduciaries and registered investment professionals. This protection is not present in the case of natural persons who seek to invest in 3(c)(1) Pools outside of the structure of such pension plans and pooled investment vehicles. Moreover, while the existing net worth and income tests provide some investor protection, we believe that additional protections may be appropriate.

The investor protections that we believe may be lacking with respect to 3(c)(1) Pools already exist for 3(c)(7) Pools.<sup>80</sup> Natural persons who invest in such pools are required to own \$5 million in certain investments at the time of their investment in the pool.<sup>81</sup> In addition, for a 3(c)(7) Pool to rely on the safe harbor provided by Regulation D, the pool must limit the sale of its securities to qualified purchasers who also meet the definition of accredited investor. Accordingly, 3(c)(7) Pools are subject to a two-step approach that is designed to provide assurance that an investor has a level of knowledge and financial sophistication and the ability to bear the economic risk of the investment in such pools, as demonstrated by the investor's investment experience and also, for natural persons, that person's net worth or income.

We believe that such a two-step approach may provide important, additional investor protections to natural persons who invest in certain 3(c)(1) Pools. Accordingly, the proposed rules governing investments in such pools incorporate that approach.

Form D contains collection of information requirements. The issuers likely to be affected by the proposed rules are companies relying on section 3(c)(1) of the Company Act and filing with the Commission on Form D a notice of sale of securities. Compliance with the notice requirements of Form D

is mandatory to the extent that a company elects to make an offering of securities in reliance on an exemption under Regulation D or section 4(6). Responses to the notice requirements are not confidential.

We estimate that if the proposed rules are adopted, the estimated burden for responding to the collection of information in Form D would not increase for most companies because the information required in the form would not change. The number of eligible accredited investors available to invest in issuers relying on section 3(c)(1) of the Company Act and registering with the Commission on Form D, however, would likely decrease. Such a decrease in accredited investors may result in either issuers reducing the number of offerings they make, or increasing the number of non-accredited investors in their pools.<sup>82</sup>

The currently approved collection of information in Form D is 17,500 hours. We estimate that there may be 20 fewer filings as a result of the proposed rules.<sup>83</sup> Accordingly, we estimate the proposed rules would reduce the annual aggregate information collection burden under Form D by 20 hours<sup>84</sup> for a total of 17,480 hours.

We request comment on the accuracy of our estimates. Pursuant to 44 U.S.C. 3506(c)(2)(B), the Commission solicits comments to: (i) Evaluate whether the proposed collection of information is necessary for the proper performance of the functions of the agency, including whether the information will have practical utility; (ii) evaluate the accuracy of the Commission's estimate of burden of the proposed collection of information; (iii) determine whether there are ways to enhance the quality, utility, and clarity of the information to be collected; and (iv) evaluate whether there are ways to minimize the burden of the collection of information on those who are to respond, including through the use of automated collection

<sup>82</sup> We note that an issuer electing to use the rule 506 exemption would not be able to sell to more than 35 non-accredited investors. See *supra* note 37.

<sup>83</sup> In fiscal year 2006, 19,250 filings were submitted to the Commission on Form D. Form D does not contain sufficient information to allow the Commission to determine whether a filer is an operating company, a 3(c)(7) Pool or a 3(c)(1) Pool. Of the 19,250 filings on Form D, we estimate that 20%, or 3,850 filings, were made by 3(c)(1) and 3(c)(7) Pools. Of those 3,850 filings, we estimate that 10%, or 385 filings, were made by filers that are 3(c)(1) Pools. Of the filers that are 3(c)(1) Pools, we estimate that 5% might not make new offerings as a result of our proposed rules, resulting in an estimated decrease of 20 filings on Form D.

<sup>84</sup> An estimated reduction of 20 filings on Form D at 1 hour each (20 × 1 = 20). We estimate that each filer spends approximately 1 hour in preparing a filing on Form D.

<sup>80</sup> See *supra* note 21.

<sup>81</sup> See *supra* note 45.

techniques or other forms of information technology.

Persons submitting comments on the collection of information requirements should direct the comments to the Office of Management and Budget, Attention: Desk Officer for the Securities and Exchange Commission, Office of Information and Regulatory Affairs, Washington, DC 20503, and should send a copy of their comments to Nancy M. Morris, Secretary, Securities and Exchange Commission, 100 F Street, NE., Washington, DC 20549-1090, with reference to File No. S7-25-06. Requests for materials submitted to OMB by the Commission with regard to this collection of information should be in writing, refer to File No. S7-25-06, and be submitted to the Securities and Exchange Commission, Records Management, Office of Filing and Information Services, 100 F Street, NE., Washington, DC 20549. OMB is required to make a decision concerning the collection of information between 30 and 60 days after publication of this Release. Consequently, a comment to OMB is best assured of having its full effect if OMB receives it within 30 days after publication of this Release.

## VI. Cost-Benefit Analysis

### A. Proposed Rule 206(4)-8

The Commission is sensitive to costs imposed by our rules and the benefits that derive from them, and is considering the costs and benefits of proposed rule 206(4)-8. The proposed rule would make it a fraudulent, deceptive or manipulative act, practice, or course of business within the meaning of section 206(4) for any investment adviser to a pooled investment vehicle to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, to any investor or prospective investor in the pooled investment vehicle. The proposed rule would also make it a fraudulent, deceptive or manipulative act, practice, or course of business within the meaning of section 206(4) for any investment adviser to a pooled investment vehicle to otherwise engage 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. For the reasons discussed below, we do not believe that the proposed rule would require advisers to incur new or additional costs.

Investment advisers to pooled investment vehicles should not be making untrue statements or omitting material facts or otherwise be engaged in fraud with respect to investors or prospective investors in pooled investment vehicles today, because federal authorities, state authorities and private litigants often can, and do, seek redress from the adviser for the untrue statements or omissions, or other frauds. In most cases, the conduct that the rule would prohibit is already prohibited by federal securities statutes,<sup>85</sup> other federal statutes (including federal wire fraud statutes),<sup>86</sup> as well as state law.<sup>87</sup>

We recognize that there are costs involved in assuring that communications to investors and prospective investors do not contain untrue or misleading statements and preventing other frauds. Advisers have incurred, and will continue to incur, these costs due to the prohibitions and deterrent effect of the law and rules that would apply under these circumstances. While each of the provisions noted above may have different limitation periods, apply in different factual circumstances, or require the government (or a private litigant) to prove different states of mind than the proposed rule, we believe that the multiple prohibitions against fraud, and the consequences under both criminal and civil law for fraud, should currently cause an adviser to take the precautions

it deems necessary to refrain from such conduct.

Furthermore, prior to *Goldstein*, advisers operated with the understanding that the Advisers Act prohibited the same conduct that would be prohibited by the proposed rule. Accordingly, we do not believe that advisers to pooled investment vehicles would need to take steps or alter their business practices in such a way that would require them to incur new or additional costs as a result of the adoption of the proposed rule.

We also recognize that the proposed rule, if adopted, may cause some advisers to pay more attention to the information they present to better guard against making an untrue or misleading statement to an investor or prospective investor and to reevaluate measures that are intended to prevent fraud. As a consequence, some advisers might seek guidance, legal or otherwise, and more closely review the information that they disseminate to investors and prospective investors and the antifraud related policies and procedures they have implemented. While increased concern about making false statements or committing fraud could be attributable to the new rule, advisers should already be incurring these costs to ensure truthfulness and prevent fraud, regardless of the proposed rule, because of the myriad of laws or regulations that may already apply.

The principal benefit of the rule is that it would clearly enable the Commission to bring enforcement actions under the Advisers Act, if an adviser to a pooled investment vehicle disseminates false or misleading information to investors or prospective investors or otherwise commits fraud with respect to any investor or prospective investor. Our enforcement actions permit us to protect fund investor assets by stopping ongoing frauds,<sup>88</sup> barring persons that have committed certain specified violations or offenses from being associated with an investment adviser,<sup>89</sup> imposing penalties,<sup>90</sup> seeking court orders to protect fund assets,<sup>91</sup> and to order disgorgement of ill-gotten gains.<sup>92</sup> Moreover, we believe that proposed rule 206(4)-8 would deter advisers to pooled

<sup>85</sup> See, e.g., section 10(b) of the Exchange Act [15 U.S.C. 78j(b)] and section 17(a) of the Securities Act which would apply when the false statements are made "in connection with the purchase or sale of a security" or involve the "offer or sale" of a security, and section 34(b) of the Company Act which makes it unlawful "to make any untrue statement of a material fact in any registration statement, application, report, account, record, or other document filed or transmitted pursuant to [the Company Act] \* \* \*".

<sup>86</sup> See, e.g., 18 U.S.C. 1341 (Frauds and swindles) and 18 U.S.C. 1343 (Fraud by wire, radio, or television) which make it a criminal offense to use the mails or to communicate by means of wire, having devised a scheme to defraud or for obtaining money or property by means of false or fraudulent pretenses, and 18 U.S.C. 1957 (Engaging in monetary transactions in property derived from specified unlawful activity) which makes it a criminal racketeering offense to engage or attempt to engage in a transaction in criminally derived property of a value greater than \$10,000.

<sup>87</sup> See, e.g., *Metro Communications Corp. BVI v. Advanced Mobilecomm Technologies, et al.*, 854 A.2d 121,156 (Del. Ch. 2004) (court held that plaintiff-former member of LLC had sufficiently alleged a common law fraud claim based on allegation that series of reports by LLC's managers contained misleading statements; court stated that "[i]n the usual fraud case, the speaking party who is subject to an accusation of fraud is on the opposite side of a commercial transaction from the plaintiff, who alleges that but for the material misstatements or omissions of the speaking party he would not have contracted with the speaking party").

<sup>88</sup> See section 203(k) (Commission authority to issue cease and desist orders).

<sup>89</sup> See section 203(f) (Commission authority to bar a person from being associated with an investment adviser).

<sup>90</sup> See section 203(i) (Commission authority to impose civil penalties).

<sup>91</sup> See section 209(d) (Commission authority to seek injunctions and restraining orders in federal court).

<sup>92</sup> See section 203(j) (Commission authority to order disgorgement).

investment vehicles from engaging in fraudulent conduct with respect to investors in those pools and would provide investors with greater confidence when investing in pooled investment vehicles.

We request comment on the assumptions on which we base our preliminary conclusion that advisers that would be subject to the new rule would not incur additional costs if we determined to adopt the rule as proposed. We encourage commenters to discuss any potential costs and benefits that we did not consider in our discussion above. We request commenters to provide analysis and empirical data to support their statements regarding any costs or benefits associated with proposed rule 206(4)–8.

#### *B. Proposed Rules 509 and 216*

The Commission is sensitive to the costs and benefits that result from its rules. We recently have taken the opportunity to reconsider the standards we established to qualify persons as accredited investors under the safe harbor provided under Regulation D and our rules for certain small offerings. We note our staff's observation in its 2003 Staff Study that "inflation, along with the sustained growth in wealth and income of the 1990s, has boosted a substantial number of investors past the 'accredited investor' standard."<sup>93</sup> Based on analysis conducted by OEA, we also note that the increase in investor wealth is due in part to the increase in the values of personal residences since 1982. Accordingly, many individual investors today may be eligible to make investments in privately offered investment pools as accredited investors that previously may not have qualified as such for those investments. Moreover, private pools have become increasingly complex and involve risks not generally associated with many other issuers of securities.<sup>94</sup> Not only do private pools often use complicated investment strategies, but there is minimal information available about them in the public domain. Accordingly, investors may not have access to the kind of information provided through our system of securities registration and therefore may find it difficult to appreciate the unique risks of these pools, including those with respect to undisclosed conflicts of interest, complex fee structures and the

higher risk that may accompany such pools' anticipated returns.

We note that natural persons may have indirect exposure to private pools as a result of their participation in pension plans and investment in certain pooled investment vehicles that invest in private pools. Such plans and vehicles are generally administered by entities of plan fiduciaries and registered investment professionals. This protection is not present in the case of natural persons who seek to invest in 3(c)(1) Pools outside of the structure of such pension plans and pooled investment vehicles. Moreover, while the existing net worth and income tests provide some investor protection, we believe that additional protections may be appropriate.

The investor protections that we believe may be lacking with respect to 3(c)(1) Pools already exist for 3(c)(7) Pools.<sup>95</sup> Natural persons who invest in such pools are required to own \$5 million in certain investments at the time of their investment in the pool.<sup>96</sup> In addition, for a 3(c)(7) Pool to rely on the safe harbor provided by Regulation D, the pool must limit the sale of its securities to qualified purchasers who also meet the definition of accredited investor. Accordingly, 3(c)(7) Pools are subject to a two-step approach that is designed to provide assurance that an investor has a level of knowledge and financial sophistication and the ability to bear the economic risk of the investment in such pools, as demonstrated by the investor's investment experience and also, for natural persons, that person's net worth or income.

We believe that such a two-step approach may provide important, additional investor protections to natural persons who invest in certain 3(c)(1) Pools. Accordingly, the proposed rules governing investments in such pools incorporate that approach.

We have identified certain costs and benefits that may result from the proposed rules. We encourage commenters to identify, discuss, analyze, and supply relevant data regarding these or any additional costs and benefits.

We believe that the proposed rules would benefit those investors who are currently accredited investors and would meet the proposed accredited natural person standard. The revised eligibility standard may benefit those accredited investors who would meet the definition of accredited natural person by increasing the competition

among 3(c)(1) Pools for their investment money. Such competition may result in lower fees. We request comment on the nature and extent of the benefits to investors that would result from increasing the accredited investor standards for natural persons investing in certain 3(c)(1) Pools.

The proposed rules may impose certain costs on affected 3(c)(1) Pools. These costs may include administrative compliance costs, such as the costs related to amending investor questionnaires and other administrative documents and procedures. These costs also could include expenses for computer time, legal and accounting fees, and information technology staff. Under the proposed rules, sponsors of an affected 3(c)(1) Pool would need to prepare and review new administrative documents and procedures, and implement such new procedures, in order to determine if prospective investors in the 3(c)(1) Pool would meet the revised accredited investor standards we propose for natural persons in connection with the offer or sale of securities issued by those pools. We expect the costs involved in complying with these proposed requirements would be minimal based on our understanding that many sponsors of 3(c)(1) Pools also sponsor 3(c)(7) Pools. We note that to the extent a sponsor of a 3(c)(1) Pool also sponsors a 3(c)(7) Pool that sponsor would already have systems in place and would be familiar with the process of evaluating investor eligibility. We solicit comment on our understanding and conclusion that the costs would be minimal. We also solicit comment on the administrative and legal costs that a sponsor of 3(c)(1) Pools that does not also sponsor 3(c)(7) Pools would incur in setting up and implementing new systems and procedures to evaluate investor eligibility. Commenters who believe that the proposed rules would impose more than minimal costs are solicited to discuss the costs of compliance that the proposed rules would impose. Commenters are asked to explain why they believe that the proposed rules would impose such costs and to quantify the costs of compliance with the proposed rules.

The proposed rules would shrink the pool of accredited investors eligible to invest in 3(c)(1) Pools.<sup>97</sup> Such a decrease in the investor base may increase competition among 3(c)(1) Pools which could lower profits and thereby possibly result in some sponsors of 3(c)(1) Pools not offering new 3(c)(1) Pools or some potential sponsors of

<sup>93</sup> 2003 Staff Study, *supra* note 3 at text accompanying note 271.

<sup>94</sup> See generally 2003 Staff Study, *id.*

<sup>95</sup> See *supra* note 21.

<sup>96</sup> See *supra* note 45.

<sup>97</sup> See *supra* note 59 and accompanying text.

such pools not entering the business. While we recognize that there are costs associated with such a decrease in the investor pool and potential new pools, we believe that these costs would be justified by the potential benefits of investor protection, and possibly lower fees resulting from increased competition.

Further, to the extent that a 3(c)(1) Pool has more than 35 investors who do not meet the increased accredited investor standards for natural persons in our proposed rules, the 3(c)(1) Pool would not be able to rely on the exclusion from registration under rule 506 of Regulation D of the Securities Act. The 3(c)(1) Pool, however, may still be able to rely on section 4(2) of the Securities Act. We request comment on the number of 3(c)(1) Pools that would be able to rely on section 4(2) of the Securities Act.

The proposed rules may also result in costs to investors. It is possible that the proposed rules could result in a diminishment of the universe of 3(c)(1) Pools available to investors. We believe, however, that such a diminishment, were it to take place, may result in increased competition among 3(c)(1) Pools which, in turn, may result in lower fees for investors.

Our proposed definition may also result in costs to previously accredited investors who would not meet the proposed accredited natural person standards. Since the proposed definition of accredited natural person is not precisely correlated with actual investment sophistication, to the extent that a sophisticated investor would no longer be considered accredited, his or her investment opportunities would decrease. We believe, that to the extent that our proposed definition captures financial sophistication for investors in 3(c)(1) Pools better than the accredited investor definition alone, the benefits would still justify the costs. We request comment on the nature and extent of the costs to private pools and investors that would result from our proposed revisions to the accredited investor standards for natural persons investing in certain 3(c)(1) Pools.

We request comments on all aspects of this cost-benefit analysis, including identification of any additional costs or benefits of the proposed rules. Commenters are requested to provide empirical data and other factual support for their views to the extent possible.

## VII. Regulatory Flexibility Act Analysis

### A. Certification for Proposed Rule 206(4)–8

Section 3(a) of the Regulatory Flexibility Act requires the Commission to undertake an Initial Regulatory Flexibility Analysis of the proposed rule on small entities unless the Commission certifies that the proposed rule, if adopted, would not have a significant economic impact on a substantial number of small entities.<sup>98</sup> Pursuant to section 605(b) of the Regulatory Flexibility Act, the Commission hereby certifies that proposed rule 206(4)–8 would not, if adopted, have a significant economic impact on a substantial number of small entities.<sup>99</sup> Proposed rule 206(4)–8 would make it a fraudulent, deceptive, or manipulative act, practice, or course of business for an investment adviser to a pooled investment vehicle to make any untrue statement of material fact or to omit to state a material fact necessary to make the statements made not misleading to any investor in the pooled investment vehicle. The proposed rule would also make it a fraudulent, deceptive or manipulative act, practice, or course of business within the meaning of section 206(4) for any investment adviser to certain pooled investment vehicles to otherwise engage 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. The rule is intended to provide the Commission with clear enforcement authority under the Advisers Act for false or misleading statements or other frauds committed by investment advisers with respect to investors in pooled investment vehicles. The conduct the rule would prohibit is already prohibited, in most cases, by laws other than the Advisers Act. As such, we do not believe that the proposed rule would have any economic impact on an investment adviser to a pooled investment vehicle, regardless of whether the investment adviser is a small entity. Accordingly, the Commission certifies that proposed rule 206(4)–8 would not have a significant economic impact on a substantial number of small entities.

The Commission encourages written comments regarding this certification. The Commission requests that commenters describe the nature of any impact on small businesses and provide empirical data to support the extent of the impact.

<sup>98</sup> 5 U.S.C. 603(a).

<sup>99</sup> 5 U.S.C. 605(b).

### B. Initial Regulatory Flexibility Analysis for Proposed Rules 509 and 216

This Initial Regulatory Flexibility Analysis has been prepared in accordance with 5 U.S.C. 603, and relates to the Commission's proposed rules 509 and 216 under the Securities Act that would revise the definition of accredited investor as it relates to natural persons. These proposed rules would apply solely to the offer and sale of certain privately offered investment pools specified in the rules. The proposed rules are designed to provide assurance that natural persons who invest in 3(c)(1) Pools have a level of knowledge and financial sophistication and the ability to bear the economic risk of the investment in such pools.

#### 1. Reasons for, and Objectives of, Proposed Rules

We recently have taken the opportunity to reconsider the standards we established to qualify persons as accredited investors under the safe harbor provided under Regulation D and our rules for certain small offerings. We note our staff's observation in its 2003 Staff Study that "inflation, along with the sustained growth in wealth and income of the 1990s, has boosted a substantial number of investors past the 'accredited investor' standard."<sup>100</sup> Based on analysis conducted by OEA, we also note that the increase in investor wealth is due in part to the increase in the values of personal residences since 1982. Accordingly, many individual investors today may be eligible to make investments in privately offered investment pools as accredited investors that previously may not have qualified as such for those investments. Moreover, private pools have become increasingly complex and involve risks not generally associated with many other issuers of securities.<sup>101</sup> Not only do private pools often use complicated investment strategies, but there is minimal information available about them in the public domain. Accordingly, investors do not have access to the kind of information provided through our system of securities registration and therefore may find it difficult to appreciate the unique risks of these pools, including those with respect to undisclosed conflicts of interest, complex fee structures and the higher risk that may accompany such pools' anticipated returns.

We note that natural persons may have indirect exposure to private pools as a result of their participation in

<sup>100</sup> 2003 Staff Study, *supra* note 3 at text accompanying note 271.

<sup>101</sup> See generally 2003 Staff Study, *id.*

pension plans and investment in certain pooled investment vehicles that invest in private pools. Such plans and vehicles are generally administered by entities of plan fiduciaries and registered investment professionals. This protection is not present in the case of natural persons who seek to invest in 3(c)(1) Pools outside of the structure of such pension plans and pooled investment vehicles. Moreover, while the existing net worth and income tests provide some investor protection, we believe that additional protections may be appropriate.

The investor protections that we believe may be lacking with respect to 3(c)(1) Pools already exist for 3(c)(7) Pools.<sup>102</sup> Natural persons who invest in such pools are required to own \$5 million in certain investments at the time of their investment in the pool.<sup>103</sup> In addition, for a 3(c)(7) Pool to rely on the safe harbor provided by Regulation D, the pool must limit the sale of its securities to qualified purchasers who also meet the definition of accredited investor. Accordingly, 3(c)(7) Pools are subject to a two-step approach which is designed to provide assurance that an investor has a level of knowledge and financial sophistication and the ability to bear the economic risk of the investment in such pools, as demonstrated by the investor's investment experience and also, for natural persons, that person's net worth or income. We believe that such a two-step approach may provide important, additional investor protections to natural persons who invest in certain 3(c)(1) Pools. Accordingly, the proposed rules governing investments in such pools incorporate that approach.

## 2. Legal Basis

The Commission is proposing new rules pursuant to authority set forth in sections 2(a)(15), 3(b), and 19(a) of the Securities Act of 1933 [15 U.S.C. 77b(15), 77c(b), and 77s(a)].

## 3. Small Entities Subject to the Rule

For purposes of the Regulatory Flexibility Act, an issuer is a "small business" or "small organization" if it has total assets of \$5 million or less as of the end of its most recent fiscal year.<sup>104</sup> Approximately 19,250 filings on Form D were made in fiscal year 2006. Of these filings, we estimate that 385 were made by private issuers that are 3(c)(1) Pools.<sup>105</sup> Of those filings made

by 3(c)(1) Pools, we estimate that 50%, or 193, of them were made by issuers that are small businesses that would be affected by the proposed rules.<sup>106</sup>

## 4. Reporting, Recordkeeping, and Other Compliance Requirements

The proposed rules would require 3(c)(1) Pools to amend their administrative procedures to evaluate whether investors meet the eligibility standards of the proposed rules.

The proposed rules would apply equally to private pools that are small entities and to other private pools. The Commission estimates that the proposed rules may result in some one-time formatting and ongoing costs and burdens that would be imposed on all affected private pools, but which may have a relatively greater impact on smaller firms. These include the costs related to amending investor questionnaires and other administrative documents and procedures, and implementing such procedures. These costs also could include expenses for computer time, legal and accounting fees, and information technology and compliance staff. However, many sponsors of 3(c)(1) Pools also sponsor 3(c)(7) Pools and therefore may already be familiar with the systems necessary to monitor the financial eligibility of investors. Commenters are solicited for their views on the effect the proposed rules would have on small entities.

## 5. Duplicative, Overlapping or Conflicting Federal Rules

There are no rules that duplicate, overlap, or conflict with the proposed rules.

## 6. Significant Alternatives

The Regulatory Flexibility Act directs us to consider significant alternatives that would accomplish our stated objective, while minimizing any significant adverse impact on small issuers. In connection with the proposed rules, the Commission considered the following alternatives: (i) The establishment of differing compliance or reporting requirements or timetables that take into account the resources available to small entities; (ii) the clarification, consolidation, or simplification of compliance and

the number of filings on Form D that were made by 3(c)(1) Pools. Of the 19,250 filings on Form D, we estimate that 20%, or 3,850 filings, were made by filers that are 3(c)(1) and 3(c)(7) Pools. Of those 3,850 filings, we estimate that 10%, or 385 filings, were made by filers that are 3(c)(1) Pools.

<sup>106</sup> Form D also does not provide the Commission with sufficient information to determine the number of filings on Form D made by small businesses. We, therefore, estimate that 50% of 3(c)(1) Pools are small businesses.

reporting requirements under the proposed rules for small entities; (iii) the use of performance rather than design standards; and (iv) an exemption from coverage of the proposed rules, or any part thereof, for small entities.

With respect to the establishment of special compliance requirements or timetables under the proposals for small entities, we do not presently think this is feasible or appropriate. The proposed rules arise from the increase in investor wealth and private pool complexity since 1982 which underscores the need to strengthen investor protections. Excepting small entities from the proposed rules could compromise the overall effectiveness of the proposed rules. Nevertheless, we request comment on whether it is feasible or appropriate for small entities to have special requirements or timetables for compliance with the proposed rules. Should the proposed rules be altered to ease the regulatory burden on small entities?

We do not believe that clarification, consolidation, or simplification of the compliance requirements is feasible. The proposed rules contain a straightforward two-step approach designed to help ensure that only investors that are capable of evaluating the merits and risks of investments in certain 3(c)(1) Pools may invest in such pools. We request comment on ways to clarify, consolidate, or simplify any part of the proposed rules.

We do not believe that the use of performance rather than design standards is feasible. We are concerned that current standards established to qualify persons as accredited investors may be insufficient under certain circumstances. The proposed rules would revise the definition of accredited investor as it relates to natural persons and may provide important, additional investor protections to natural persons who invest in certain 3(c)(1) Pools.

With respect to exempting small entities from coverage of these proposed rules, we believe such changes would be impracticable. We have endeavored throughout these proposed rules to minimize the regulatory burden on all affected private pools, including small entities, while meeting our regulatory objectives. Exemption from the proposals for private pools that are small entities would be inconsistent with the Commission's goal of investor protection.

## 7. Solicitation of Comments

The Commission encourages the submission of written comments with respect to any aspect of this analysis.

<sup>102</sup> See *supra* note 21.

<sup>103</sup> See *supra* note 45.

<sup>104</sup> 17 CFR 230.157.

<sup>105</sup> Form D does not contain sufficient information to allow the Commission to determine



Comment is specifically requested on the number of small entities that would be affected by the proposed rules and the likely impact of the proposals on small entities. Commenters are asked to describe the nature of any impact and provide empirical data supporting the extent of the impact. These comments will be considered in the preparation of the Final Regulatory Flexibility Analysis, if the proposed rules are adopted, and will be placed in the same public file as comments on the proposed rules themselves.

**VIII. Effects on Competition, Efficiency and Capital Formation**

Section 2(b) of the Securities Act requires the Commission, when engaging in rulemaking that requires it to consider or determine whether an action is necessary or appropriate in the public interest, to consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.<sup>107</sup>

The proposed rules are designed to provide assurance that an accredited investor has a level of knowledge and financial sophistication and the ability to bear the economic risk of an investment in a 3(c)(1) Pool, as demonstrated by the investor's investment experience and also, for natural persons, that person's net worth or income. These proposed rules may affect efficiency. Since the proposed enhanced eligibility standards would result in a smaller pool of accredited investors eligible to invest in 3(c)(1) Pools, competition among private pools for investors may increase resulting in more efficient allocation of assets among private pools. The proposed standards, however, also may have an inefficient allocation result in certain circumstances. The proposed rules, for example, may result in certain investors who are knowledgeable and financially sophisticated but who do not meet the parameters of the proposed rules not being able to invest in 3(c)(1) Pools.

Competition may also be affected by the proposed rules. They may promote competition by shrinking the pool of investors eligible to invest in 3(c)(1) Pools. Such a decrease in the investor base may increase competition among 3(c)(1) Pools which could lower profits and thereby possibly result in some sponsors of 3(c)(1) Pools not offering new 3(c)(1) Pools or some potential sponsors of such pools not entering the business.

Finally, the proposed rules would affect capital formation by decreasing the pool of investors from which 3(c)(1)

Pools would be able to obtain capital to start or increase the size of their private pools.

We request comment on whether the proposed rules, if adopted, would promote efficiency, competition and capital formation. We specifically request comment on the effect a decrease in the eligible investor base will have on competition. Commenters are solicited for their views on the impact that applying the proposed rules would have on the ability of affected 3(c)(1) Pools to raise capital. For example, commenters are requested to discuss how much capital they believe that 3(c)(1) Pools historically have raised (total amount and percentage of assets of the pool) through the offer and sale of their securities to persons who would meet the current definition of accredited investor under Regulation D, but who would not meet the definition of accredited natural person. Commenters are requested to provide empirical data and other factual support for their views if possible.

**IX. Statutory Authority**

We are proposing new rules 509 and 216 pursuant to our authority set forth in sections 2(a)(15), 3(b) and 19(a) of the Securities Act [15 U.S.C. 77b(15), 77c(b) and 77s(a)]. We are proposing new rule 206(4)-8 pursuant to our authority set forth in sections 206(4) and 211(a) of the Advisers Act [15 U.S.C. 80b-6(4) and 80b-11(a)].

**List of Subjects**

*17 CFR Part 230*

Investment companies, Reporting and recordkeeping, Securities.

*17 CFR Part 275*

Reporting and recordkeeping, Securities.

**Text of Proposed Rules**

For the reasons set out in the preamble, Title 17, Chapter II of the Code of Federal Regulations is proposed to be amended as follows:

**PART 230—GENERAL RULES AND REGULATIONS, SECURITIES ACT OF 1933**

1. The general authority citation for Part 230 is revised to read as follows:

**Authority:** 15 U.S.C. 77b, 77c, 77d, 77f, 77g, 77h, 77j, 77r, 77s, 77z-3, 77sss, 78c, 78d, 78j, 78l, 78m, 78n, 78o, 78t, 78w, 78ll (d), 78mm, 80a-8, 80a-24, 80a-28, 80a-29, 80a-30, and 80a-37, unless otherwise noted.

\* \* \* \* \*

2. Section 230.215 is amended by revising paragraphs (e) and (f) to read as follows:

**§ 230.215 Accredited investor.**

\* \* \* \* \*

(e) Any natural person whose individual net worth, or joint net worth with that person's spouse, at the time of his purchase exceeds \$1,000,000, except that § 230.216 shall apply with respect to the sale of securities issued by a "private investment vehicle" as described therein;

(f) Any natural person who had an individual income in excess of \$200,000 in each of the two most recent years or joint income with that person's spouse in excess of \$300,000 in each of those years and has a reasonable expectation of reaching the same income level in the current year, except that § 230.216 shall apply with respect to the sale of securities issued by a "private investment vehicle" as described therein;

\* \* \* \* \*

3. By adding § 230.216 before the undesignated section heading to read as follows:

**§ 230.216 Accredited investor definition for investors in certain private investment vehicles.**

(a) Notwithstanding the definition of the term "accredited investor" in § 230.215, 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" as used in section 4(6) of the Securities Act of 1933 (15 U.S.C. 77(d)(6)) with reference to a natural person for purposes of § 230.215(e) or § 230.215(f) ("accredited natural person") shall mean a natural person who meets the requirements specified in § 230.215(e) or § 230.215(f), and who owns (individually, or jointly with that person's spouse) not less than \$2.5 million (as adjusted for inflation) in investments.

(b) *Definitions.* As used in this section, the following terms shall have the meanings indicated:

(1) *Private investment vehicle* means any issuer that would be an investment company as defined in section 3(a) of the Investment Company Act of 1940 (15 U.S.C. 80a-3(a)) but for the exclusion provided for in section 3(c)(1) (15 U.S.C. 80a-3(c)(1)) of that Act.

(2) *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)).

(3) *Investments* means:

(i) Securities (as defined by section 2(a)(1) of the Act (15 U.S.C. 77b(a)(1))), other than securities issued by an issuer that is controlled by the prospective

<sup>107</sup> 15 U.S.C. 77(b).

accredited natural person that owns such securities, unless such issuer is:

(A) An investment company, as defined in section 3(a) of the Investment Company Act of 1940 (15 U.S.C. 80a-3(a)), or a company that would be an investment company under section 3(a) but for the exclusions from that definition provided by sections 3(c)(1) through 3(c)(9) of the Investment Company Act (15 U.S.C. 80a-3(c)(1) through 3(c)(9)), or the exclusions provided by § 270.3a-6 or § 270.3a-7 of this chapter, or a commodity pool;

(B) A company that:

(1) Files reports pursuant to section 13 or 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78m or 78o(d)); or

(2) Has a class of securities that are listed on a "designated offshore securities market" as such term is defined by Regulation S under the Act (§§ 230.901 through 230.904); or

(C) A company with shareholders' equity of not less than \$50 million (determined in accordance with generally accepted accounting principles) as reflected on the company's most recent financial statements, provided that such financial statements present the information as of a date within 16 months preceding the date on which the prospective accredited natural person acquires the securities of a private investment vehicle;

(ii) Real estate held for investment purposes;

(iii) Commodity interests held for investment purposes. For purposes of this section, *commodity interests* means commodity futures contracts, options on commodity futures contracts, and options on physical commodities traded on or subject to the rules of:

(A) Any contract market designated for trading such transactions under the Commodity Exchange Act (7 U.S.C. 1 *et seq.*) and the rules thereunder (17 CFR 1.1 through 190.10); or

(B) Any board of trade or exchange outside the United States, as contemplated in Part 30 of the rules under the Commodity Exchange Act (17 CFR 30.1 through 30.12);

(iv) Physical commodities held for investment purposes. For purposes of this paragraph, *physical commodities* means any physical commodity with respect to which a commodity interest is traded on a market specified in paragraph (b)(3)(iii) of this section;

(v) To the extent not securities, financial contracts (as such term is defined in section 3(c)(2)(B)(ii) of the Investment Company Act of 1940 (15 U.S.C. 80a-3(c)(2)(B)(ii))) entered into for investment purposes; and

(vi) Cash and cash equivalents (including foreign currencies) held for investment purposes. For purposes of this section, cash and cash equivalents include:

(A) Bank deposits, certificates of deposit, bankers acceptances and similar bank instruments held for investment purposes; and

(B) The net cash surrender value of an insurance policy.

(4) *Prospective accredited natural person* means a natural person seeking to purchase a security issued by a private investment vehicle.

(5) *Related person* means a natural person who is related to a prospective accredited natural person as a sibling, spouse or former spouse, or is a direct lineal descendant or ancestor by birth or adoption of the prospective accredited natural person, or is a spouse of such descendant or ancestor.

(c) Solely for purposes of this section:

(1) *Investment purposes*:

(i) Real estate shall not be considered to be held for investment purposes by a prospective accredited natural person if it is used by the prospective accredited natural person or a related person for personal purposes or as a place of business, or in connection with the conduct of the trade or business of the prospective accredited natural person or a related person, provided that real estate owned by a prospective accredited natural person who is engaged primarily in the business of investing, trading or developing real estate in connection with such business may be deemed to be held for investment purposes. Residential real estate shall not be deemed to be used for personal purposes if deductions with respect to such real estate are not disallowed by section 280A of the Internal Revenue Code (26 U.S.C. 280A).

(ii) A commodity interest or physical commodity owned, or a financial contract entered into, by the prospective accredited natural person who is engaged primarily in the business of investing, reinvesting, or trading in commodity interests, physical commodities or financial contracts in connection with such business may be deemed to be held for investment purposes.

(2) *Valuation*. For purposes of determining whether a natural person is an accredited natural person, the aggregate amount of investments owned and invested on a discretionary basis by the natural person shall be the investments' fair market value on the most recent practicable date or their cost, provided that:

(i) In the case of commodity interests, the amount of investments shall be the

value of the initial margin or option premium deposited in connection with such commodity interests; and

(ii) In each case, there shall be deducted from the amount of investments owned by the natural person the amounts specified in paragraph (c)(3) of this section, as applicable.

(3) *Deductions*. In determining whether any natural person is an accredited natural person there shall be deducted from the amount of such person's investments the amount of any outstanding indebtedness incurred to acquire or for the purpose of acquiring the investments owned by such person.

(4) *Joint investments*. In determining whether a natural person is an accredited natural person, there may be included in the amount of such person's investments any investments held individually and fifty percent of any investments (a) held jointly with such person's spouse, and (b) in which such person shares with such person's spouse a community property or similar shared ownership interest. In determining whether spouses who are making a joint investment in a private investment vehicle are accredited natural persons, there may be included in the amount of each spouse's investments any investments owned by the other spouse (whether or not such investments are held jointly). In each case, there shall be deducted from the amount of any such investments the amounts specified in paragraph (c)(3) of this section incurred by each spouse; and

(5) *Certain retirement plans and trusts*. In determining whether a natural person is an accredited natural person, there may be included in the amount of such person's investments any investments held in an individual retirement account or similar account the investments of which are directed by and held for the benefit of such person.

(6) *Inflation adjustments*.

(i) On April 1, 2012, and on the 1st day of each subsequent 5-year period, the dollar amount in paragraph (a) of this section shall be adjusted by:

(A) Dividing the annual value of the Personal Consumption Expenditures Chain-Type Price Index (or any successor index thereto), as published by the Department of Commerce, for the calendar year preceding the calendar year in which the adjustment is being made by the annual value of such index (or successor) for the calendar year ending December 31, 2006; and

(B) Multiplying the dollar amount by the quotient obtained in paragraph (c)(6)(i)(A) of this section.

(ii) *Rounding*. If the adjusted dollar amount determined under paragraph (c)(6)(i) of this section for any period is not a multiple of \$100,000, the amount so determined shall be rounded to the nearest multiple of \$100,000.

4. Section 230.501 is amended by revising paragraphs (a)(5) and (a)(6) to read as follows:

**§ 230.501 Definitions and terms used in Regulation D.**

(a) \* \* \*

(5) Any natural person whose individual net worth, or joint net worth with that person's spouse, at the time of his purchase exceeds \$1,000,000, except that § 230.509 shall apply with respect to the sale of securities issued by a "private investment vehicle" as described therein;

(6) Any natural person who had an individual income in excess of \$200,000 in each of the two most recent years or joint income with that person's spouse in excess of \$300,000 in each of those years and has a reasonable expectation of reaching the same income level in the current year, except that § 230.509 shall apply with respect to the sale of securities issued by a "private investment vehicle" as described therein;

\* \* \* \* \*

5. By adding § 230.509 to read as follows:

**§ 230.509 Private investment vehicle.**

(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 § 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 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.

(b) *Definitions*. As used in this section, the following terms shall have the meanings indicated:

(1) *Private investment vehicle* means any issuer that would be an investment company as defined in section 3(a) of the Investment Company Act of 1940 (15 U.S.C. 80a-3(a)) but for the exclusion provided for in section 3(c)(1)(15 U.S.C. 80a-3(c)(1)) of that Act.

(2) *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)).

(3) *Investments* means:

(i) Securities (as defined by section 2(a)(1) of the Act (15 U.S.C. 77b(a)(1))), other than securities issued by an issuer that is controlled by the prospective accredited natural person that owns such securities, unless such issuer is:

(A) An investment company, as defined in section 3(a) of the Investment Company Act of 1940 (15 U.S.C. 80a-3(a)), or a company that would be an investment company under section 3(a) but for the exclusions from that definition provided by sections 3(c)(1) through 3(c)(9) of the Investment Company Act (15 U.S.C. 80a-3(c)(1) through 3(c)(9)), or the exclusions provided by § 270.3a-6 or § 270.3a-7 of this chapter, or a commodity pool;

(B) A company that:

(1) Files reports pursuant to section 13 or 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78m or 78o(d)); or

(2) Has a class of securities that are listed on a "designated offshore securities market" as such term is defined by Regulation S under the Act (§§ 230.901 through 230.904); or

(C) A company with shareholders' equity of not less than \$50 million (determined in accordance with generally accepted accounting principles) as reflected on the company's most recent financial statements, provided that such financial statements present the information as of a date within 16 months preceding the date on which the prospective accredited natural person acquires the securities of a private investment vehicle;

(ii) Real estate held for investment purposes;

(iii) Commodity interests held for investment purposes. For purposes of this section, *commodity interests* means commodity futures contracts, options on commodity futures contracts, and options on physical commodities traded on or subject to the rules of:

(A) Any contract market designated for trading such transactions under the Commodity Exchange Act (7 U.S.C. 1 *et seq.*) and the rules thereunder (17 CFR 1.1 through 190.10); or

(B) Any board of trade or exchange outside the United States, as contemplated in Part 30 of the rules under the Commodity Exchange Act (17 CFR 30.1 through 30.12);

(iv) Physical commodities held for investment purposes. For purposes of this paragraph, *physical commodities*

means any physical commodity with respect to which a commodity interest is traded on a market specified in paragraph (b)(3)(iii) of this section;

(v) To the extent not securities, financial contracts (as such term is defined in section 3(c)(2)(B)(ii) of the Investment Company Act of 1940 (15 U.S.C. 80a-3(c)(2)(B)(ii)) entered into for investment purposes; and

(vi) Cash and cash equivalents (including foreign currencies) held for investment purposes. For purposes of this section, cash and cash equivalents include:

(A) Bank deposits, certificates of deposit, bankers acceptances and similar bank instruments held for investment purposes; and

(B) The net cash surrender value of an insurance policy.

(4) *Prospective accredited natural person* means a natural person seeking to purchase a security issued by a private investment vehicle.

(5) *Related person* means a natural person who is related to a prospective accredited natural person as a sibling, spouse or former spouse, or is a direct lineal descendant or ancestor by birth or adoption of the prospective accredited natural person, or is a spouse of such descendant or ancestor.

(c) Solely for purposes of this section:

(1) *Investment purposes*:

(i) Real estate shall not be considered to be held for investment purposes by a prospective accredited natural person if it is used by the prospective accredited natural person or a related person for personal purposes or as a place of business, or in connection with the trade or business of the prospective accredited natural person or a related person, provided that real estate owned by a prospective accredited natural person who is engaged primarily in the business of investing, trading or developing real estate in connection with such business may be deemed to be held for investment purposes. Residential real estate shall not be deemed to be used for personal purposes if deductions with respect to such real estate are not disallowed by section 280A of the Internal Revenue Code (26 V.S.C. 280A).

(ii) A commodity interest or physical commodity owned, or a financial contract entered into, by the prospective accredited natural person who is engaged primarily in the business of investing, reinvesting, or trading in commodity interests, physical commodities or financial contracts in connection with such business may be deemed to be held for investment purposes.

(2) *Valuation.* For purposes of determining whether a natural person is an accredited natural person the aggregate amount of investments owned and invested on a discretionary basis by the natural person shall be the investments' fair market value on the most recent practicable date or their cost, provided that:

(i) In the case of commodity interests, the amount of investments shall be the value of the initial margin or option premium deposited in connection with such commodity interests; and

(ii) In each case, there shall be deducted from the amount of investments owned by the natural person the amounts specified in paragraph (c)(3) of this section, as applicable.

(3) *Deductions.* In determining whether any natural person is an accredited natural person there shall be deducted from the amount of such person's investments the amount of any outstanding indebtedness incurred to acquire or for the purpose of acquiring the investments owned by such person.

(4) *Joint investments.* In determining whether a natural person is an accredited natural person, there may be included in the amount of such person's investments any investments held individually and fifty percent of any investments (a) held jointly with such person's spouse, and (b) in which such person shares with such person's spouse a community property or similar shared ownership interest. In determining whether spouses who are making a joint investment in a private investment vehicle are accredited natural persons, there may be included in the amount of each spouse's investments any investments owned by the other spouse (whether or not such investments are held jointly). In each case, there shall be

deducted from the amount of any such investments the amounts specified in paragraph (c)(3) of this section incurred by each spouse; and

(5) *Certain retirement plans and trusts.* In determining whether a natural person is an accredited natural person, there may be included in the amount of such person's investments any investments held in an individual retirement account or similar account the investments of which are directed by and held for the benefit of such person.

(6) *Inflation adjustments.*

(i) On April 1, 2012, and on the 1st day of each subsequent 5-year period, the dollar amount in paragraph (a) of this section shall be adjusted by:

(A) Dividing the annual value of the Personal Consumption Expenditures Chain-Type Price Index (or any successor index thereto), as published by the Department of Commerce, for the calendar year preceding the calendar year in which the adjustment is being made by the annual value of such index (or successor) for the calendar year ending December 31, 2006; and

(B) Multiplying the dollar amount by the quotient obtained in paragraph (c)(6)(i)(A) of this section.

(ii) *Rounding.* If the adjusted dollar amount determined under paragraph (c)(6)(i) of this section for any period is not a multiple of \$1 00,000, the amount so determined shall be rounded to the nearest multiple of \$100,000.

#### **PART 275—RULES AND REGULATIONS, INVESTMENT ADVISERS ACT OF 1940**

6. The authority citation for part 275 continues to read in part as follows:

**Authority:** 15 U.S.C. 80b-2(a)(11)(F), 80b-2(a)(17), 80b-3, 80b-4, 80b-4a, 80b-6(4), 80b-6a, and 80b-II, unless otherwise noted.

\* \* \* \* \*

7. Section 275.206(4)-8 is added to read as follows:

#### **§ 206(4)-8 Pooled investment vehicles.**

(a) *Prohibition.* It shall constitute a fraudulent, deceptive, or manipulative act, practice, or course of business within the meaning of section 206(4) of the Act (15 U.S.C. 80b-6(4)) for any investment adviser to a pooled investment vehicle to:

(1) Make any untrue statement of a material fact or to omit to state a material fact necessary to make the statements made, in the light of the circumstances under which they were made, not misleading, to any investor or prospective investor in the pooled investment vehicle; or

(2) Otherwise engage 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.

(b) *Definition.* For purposes of this section "pooled investment vehicle" means any investment company as defined in section 3(a) of the Investment Company Act of 1940 (15 U.S.C. 80a-3(a)) or any company that would be an investment company under section 3(a) of that Act but for the exclusion provided from that definition by either section 3(c)(1) or section 3(c)(7) of that Act (15 U.S.C. 80a-3(c)(1) or (7)).

By the Commission.

Dated: December 27, 2006.

**Jill M. Peterson,**

*Assistant Secretary.*

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