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SEC PROPOSED RULEMAKING ON PROHIBITION OF FRAUD BY ADVISORS AND REVISED STANDARDS FOR ACCREDITED INVESTORS

On December 27, 2006, the U.S. Securities and Exchange Commission (the "Commission") issued Release No. 1A-2576 (the "Release"), in which it proposed new rules designed to provide additional investor protections that would affect pooled investment vehicles, including hedge funds. First, the Commission proposed a rule that would prohibit advisors to pooled investment vehicles, including advisors that are not required to be registered as investment advisors with the Commission under the Investment Advisers Act of 1940 (the "Investment Advisers Act"), from making false or misleading statements or otherwise defrauding investors or prospective investors in those pooled investment vehicles. Second, the Commission proposed rules that would redefine "accredited investors" as the term relates to natural persons as investors in certain private investment vehicles, including hedge funds.

As a result of the decision in *Goldstein v. Securities and Exchange Commission*, 451 F.3d 873 (D.C. Cir. 2006), which nullified the Commission's hedge-fund advisor registration rule, the Commission proposed these two rules to bolster investor protection in pooled investment vehicles. If adopted, these rules will significantly affect how advisors to pooled investment vehicles, including private equity funds, hedge funds, hedge funds of funds, venture capital funds, collateralized loan obligation funds, structured investment vehicles, real estate funds, and other funds, communicate with their investors and operate and to whom the securities of certain of these pooled investment vehicles may be offered.

ANTI-FRAUD RULE FOR POOLED INVESTMENT VEHICLES

The Commission proposed a new rule under the Investment Advisers Act that would enable the Commission to bring enforcement actions against investment advisors to "pooled investment vehicles" for (1) making untrue statements of a material fact or omitting to state a material fact necessary to make the

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statements made, in light of the circumstances under which they were made, not misleading to any investor or prospective investor in a pooled investment vehicle, or (2) engaging in any act, practice, or course of business that is fraudulent, deceptive, or manipulative with respect to investors or prospective investors in pooled investment vehicles.

This proposed rule would apply to any pooled investment vehicle that is exempt from the Investment Company Act of 1940 (the "Investment Company Act") pursuant to the exclusions provided by either Section 3(c)(1) or 3(c)(7) of the Investment Company Act. Pooled investment vehicles that meet this definition include hedge funds, hedge funds of funds, venture capital funds, private equity funds, certain real estate funds, collateralized loan obligation funds, structured investment vehicles, and any other private funds relying on either the Section 3(c)(1) or 3(c)(7) exemptions. Under Section 3(c)(1), a fund is generally excluded from the definition of investment company if its securities are not publicly offered and its securities (other than short-term paper) are owned by not more than 100 persons. Under Section 3(c)(7), a fund is generally excluded from the definition of investment company if its securities are not publicly offered and at the time of acquisition are owned only by "qualified purchasers" (*i.e.*, natural persons with $5 million or more in investments, or institutions with $25 million or more in investments).

The rule is intended to apply to the investment advisors to these pooled investment vehicles, whether or not these advisors are registered as investment advisors under the Investment Advisers Act. If adopted, the rule would enable the Commission to bring enforcement actions for violations of this rule against any advisor to a pooled investment vehicle.

The types of false and misleading statements that could trigger enforcement actions would not necessarily have to be linked to securities offerings of the pooled investment vehicles. Such actions could be triggered by false and misleading statements in periodic reports and other communications with investors or potential investors. The types of false and misleading statements cited by the Commission in the Release include statements regarding the description of current and prospective pool investment strategies; the experience and credentials of the advisor and its personnel; the risks associated with an investment in the pool; the performance of the pool or other funds advised by the advisor; the valuation of the pool or investor accounts; and the practices the advisor follows in the operation of its advisory business, such as investment opportunity allocations, use of soft dollar arrangements, and investor side letters.

The rule would also give the Commission broad authority to bring enforcement actions for acts, practices, or courses of business that the Commission determines are fraudulent, deceptive, or manipulative with respect to investors or prospective investors in pooled investment vehicles. The rule is deliberately broad in its terms and enables the Commission to bring enforcement actions in unspecified areas it finds to be justified.

Enforcement actions by the Commission do not necessarily have to involve offerings of securities but can include any communications to investors as well as investment advisor practices with regard to the operation of pooled investment vehicles. In addition, the Commission does not have to require a finding of *scienter* (*i.e.*, intent by the advisor to deceive, manipulate, or defraud) to bring such an enforcement action.

The Release states that the proposed rule is not intended to create a private right of action against the advisor.

Lastly, the Release makes clear that the proposed rule would not, in and of itself, create a fiduciary duty to investors or prospective investors that is not otherwise imposed by the law, nor would it modify other federal or state laws or regulations relating to investors in a pooled investment vehicle.

AMENDMENTS TO THE PRIVATE OFFERING RULES UNDER THE SECURITIES ACT

The Commission has proposed rules to redefine "accredited investors" as the term relates to natural persons as investors in private investment vehicles (other than certain venture capital funds) for purposes of meeting the private placement exemption of Regulation D promulgated under the Securities Act of 1933 (the "Securities Act") as well as for purposes of

the small offering exemption from registration under the Securities Act.

“Private investment vehicle” under these proposed rules is defined to include any fund that fits within the exclusion of being an investment company under Section 3(c)(1) of the Investment Company Act, other than certain venture capital funds. For this purpose, “venture capital funds” has the same meaning as “business development companies” under the Investment Advisers Act. Generally, “business development companies” as defined in the Investment Advisers Act are entities organized in the United States and operated for the purpose of making investments with respect to at least 60 percent of the value of their total assets in issuers that are “eligible portfolio companies,” including companies that are not reporting companies under the Securities Exchange Act of 1934 or certain issuers that have recently been involved in bankruptcy proceedings.

Private investment vehicles that are exempt from the Investment Company Act under Section 3(c)(7) funds are not affected by this proposed rule because investors in 3(c)(7) funds are generally required to be qualified purchasers and are thought to have sufficient levels of sophistication and investment expertise to be able to evaluate investments in these pooled vehicles without the protection of the proposed rule.

In order for an investor in a private investment vehicle that is a natural person to be an “accredited investor” under proposed Regulation D of the Securities Act, the investor must not only meet the income or net-worth tests currently in Regulation D (*i.e.*, at the time of purchase have income in each of the last two years of $200,000 (or $300,000 if counted with one’s spouse) and a reasonable expectation that such income level will be reached in the coming year, or have a net worth of at least $1 million), but must also own, either individually or jointly with that person’s spouse, not less than $2.5 million in “investments” (as adjusted for inflation).

The definition of “investments” is similar to the definition of “investments” in the regulations under the Investment Company Act defining a “qualified purchaser” and includes securities (other than those issued by affiliated issuers), real estate held for investment, commodity interests held for investment, certain financial contracts such as swap agreements held for investment, cash, cash equivalents, bank deposits, and the cash surrender value of life insurance contracts.

The effect of the proposed rule is to significantly limit the natural-person investors in private investment vehicles that rely on the exemption under Section 3(c)(1) of the Investment Company Act to include only investors that have significant investment portfolios. An expected result of the proposed rule is slowing, if not stopping, the “retailization” of investment in these funds. The proposed rule would also preclude investment by “knowledgeable employees” of the advisor who might otherwise have sufficient investment expertise, but not the appropriate level of investment portfolios to qualify, which is a significant disincentive to certain otherwise capable insiders. The Commission has solicited comments on this point.

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