



# GlobalNote

## **PROPOSED RULE TO PROHIBIT FRAUD BY INVESTMENT ADVISERS AND PROPOSED REVISIONS TO THE DEFINITION OF ACCREDITED INVESTOR<sup>1</sup>**

**To: Clients and Friends of Tannenbaum Helpern Syracuse & Hirschtritt LLP**

**Date: January 17, 2007**

### **Summary**

On December 27, 2006, the Securities and Exchange Commission (the “SEC”) issued a release entitled “Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles; Accredited Investors in Certain Private Investment Vehicles,” Release No. 33-8766 (the “Proposal”), which proposes enactment of new rules that are of particular relevance to hedge funds and their advisers.<sup>2</sup> The SEC issued the Proposal in response to concerns about an increase in hedge fund investments.<sup>3</sup> The opportunity for the public to comment on the Proposal will expire on March 9, 2007.

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<sup>1</sup> This memorandum provides general information on the subject matter described, and it should not be relied on for legal advice on any matter, which may turn on specific facts. You should seek specific legal advice before acting with regard to the subjects addressed here.

<sup>2</sup> The Proposal is available online at <http://www.sec.gov/rules/proposed/2006/33-8766.pdf>.

<sup>3</sup> In the Proposal, the SEC refers to a 2003 report issued by the staff of the SEC’s Division of Investment Management and Office of Compliance Inspections and Examinations entitled, “Implications of the Growth of Hedge Funds” (available at <http://www.sec.gov/spotlight/hedgefunds.htm>) (the “2003 Staff Study”), and an analysis conducted by the SEC’s Office of Economic Analysis, which point to substantial growth in the number of investors who have become eligible to invest in hedge funds as “accredited investors” due to the rising value of residential properties since 1982, inflation and increased wealth and incomes. The 2003 Staff Study cites a concern that hedge funds may increasingly seek out these investors as a source of capital and that such investors may be in need of greater protection given their increased exposure to such investment alternatives. See, 2003 Staff Study, p. 81, and the discussion regarding the “retailization” of hedge funds.

First, the SEC is proposing to adopt a new antifraud rule under section 206(4) of the Investment Advisers Act of 1940, as amended (the “Advisers Act”), that is designed to prevent advisers to “pooled investment vehicles”<sup>4</sup> from making any untrue statement of a material fact (or omitting to state a material fact necessary to make a statement, in light of the circumstances under which it was made, not misleading) or otherwise engaging in any act or practice that is fraudulent, deceptive or manipulative with respect to any investors or prospective investors in those vehicles. The proposed antifraud rule is wide in scope and will likely necessitate a review of all communications (including, but not limited to, account statements, private placement memoranda, offering circulars and responses to “requests for proposals”) to current and potential investors.

Second, the SEC is proposing to enact two rules that would supplement the definition of “accredited investor” under the Securities Act of 1933, as amended (the “Securities Act”) and the rules promulgated thereunder.<sup>5</sup> The proposed rules establish a two-part test that natural persons will need to meet in order to invest in those hedge funds that are excluded from the definition of “investment company” by section 3(c)(1) of the Investment Company Act of 1940, as amended (the “Company Act”) (such funds are referred to herein as “3(c)(1) funds”). Natural persons who meet the two-part test would be called “accredited natural persons” under the new rules. Accredited natural persons will be required to meet income or net worth thresholds as well as demonstrate that they own sufficient “investments” (as defined in the proposed rules) in order to qualify. In contrast, the proposed rules will not apply to investors in funds excluded by section 3(c)(7) of the Company Act (“3(c)(7) funds”) because such investors have to qualify under a higher standard than is presently necessary for investors in 3(c)(1) funds.

## **Discussion**

### **I. Fraudulent, Deceptive or Manipulative Acts - Proposed Rule 206(4)-8 Under Section 206(4) of the Advisers Act**

Proposed rule 206(4)-8 would prohibit investment advisers from engaging in certain fraudulent conduct with respect to potential and current investors in the privately offered investment vehicles they manage.

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<sup>4</sup> “Pooled investment vehicles”, as defined in proposed rule 206(4)-8, means any investment company as defined in section 3(a) of the Investment Company Act of 1940, as amended, 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 3(c)(7) of that Act.

<sup>5</sup> “Accredited investor” is defined in three places in the Securities Act. With respect to offerings made under section 4(6), the accredited investor definition is contained in section 2(a)(15)(i) of the Securities Act and rule 215 under the Securities Act. With respect to private offerings made pursuant to the Regulation D safe harbor (as defined herein), the definition of “accredited investor” is located in rule 501(a) of that regulation. The accredited investor definitions under section 4(6) of the Securities Act and Regulation D are the same.

## 1. Legal and Factual Background

Section 206 of the Advisers Act is usually referred to as the “anti-fraud” rule. For purposes of this discussion, there are three relevant subsections – 206(1), 206(2) and 206(4).

Sections 206(1) and (2) of the Advisers Act prohibit investment advisers from engaging in fraudulent behavior with respect to their “clients”. In *Goldstein v. Securities and Exchange Commission*<sup>6</sup> (“Goldstein”), the court stated that an investment adviser’s “client” refers to the investment vehicle it advises, not the vehicle’s individual investors. As the SEC noted in its commentary to the Proposal, Goldstein’s definition of “client” created uncertainty with respect to the SEC’s ability to bring enforcement actions under section 206(1) or (2) against investment advisers who engage in fraudulent conduct with respect to investors and prospective investors in their pooled investment vehicles.

Under section 206(4) of the Advisers Act, the SEC is authorized to adopt rules designed to prevent any act, practice or course of business that is fraudulent, deceptive or manipulative. The SEC’s authority under this section is not limited to conduct aimed at “clients”. This section, in the SEC’s view, provides it with the authority to propose new rule 206(4)-8, which would prohibit advisers from (i) making false or misleading statements, or omitting to state material facts necessary to render a statement, in light of the circumstances in which it was made, not misleading, to any investor or prospective investor in a pooled investment vehicle, or (ii) 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 a pooled investment vehicle. Accordingly, rule 206(4)-8 is the key to the new SEC proposals.

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

The proposed rule applies to both registered and unregistered investment advisers with respect to investors and prospective investors in “pooled investment vehicles”.<sup>7</sup>

With respect to the proposed rule’s application to unregistered advisers, the SEC acknowledges that this is a departure from the other antifraud rules under section 206(4)<sup>8</sup> in that such rules only apply to registered investment advisers. The Proposal notes that the SEC has proposed that new rule 206(4)-8 apply to all investment advisers as its goal is to prohibit all practices that defraud or deceive pool investors.<sup>9</sup>

Finally, new rule 206(4)-8 would apply to any advisers with respect to the “pooled investment vehicles” that they advise regardless of the investment strategy they employ or the structure or type of vehicle they manage. The commentary in the Proposal notes that the rule would apply to investment advisers subject to section 206 of the

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<sup>6</sup> 451 F.3d 873 (D.C. Cir. 2006).

<sup>7</sup> See footnote 4, *supra*, for the definition of “pooled investment vehicles.”

<sup>8</sup> Rules 206(4)-1 through 7 under the Advisers Act.

<sup>9</sup> *See*, Proposal, p. 9.

Advisers Act with respect to the hedge funds, private equity funds, venture capital funds, and other types of privately offered pools that they advise.

### 3. Prohibition on False or Misleading Statements

Under proposed rule 206(4)-8(a)(1), any investment adviser to a pooled investment vehicle that 1) makes, to any investor or prospective investor in a pooled investment vehicle, any untrue statement of a material fact, or 2) omits to state a material fact necessary to make a statement, in light of the circumstances under which it was made, not misleading, would be engaging in a fraudulent, deceptive or manipulative act, practice or course of business within the meaning of section 206(4) of the Advisers Act. Note that the focus of the proposed rule is statements and omissions directed to the ultimate investor or prospective investor in the vehicle.

Significantly, ordinary negligence would be sufficient grounds for a violation of the proposed rule. The Proposal distinguishes between this antifraud provision and other antifraud provisions under the Securities Act and the Securities Exchange Act of 1934, as amended (the “Exchange Act”) in that other rules that focus on fraud in the offer, purchase or sale of securities generally require proof of “scienter” (i.e., intent to defraud) by the issuer – a more difficult standard to meet.<sup>10</sup> Thus, according to the Proposal, materially false or misleading statements in a private placement memorandum, even if unintentionally made, could be grounds for an enforcement action by the SEC against the adviser responsible for those statements.<sup>11</sup> The Proposal focuses on statements made in the private placement memorandum of a pooled investment vehicle relating to the (i) investment strategy, (ii) experience and credentials of the adviser, (iii) risk factors, (iv) valuation of the fund or investor accounts in it and (v) practices that the adviser follows in the operation of its advisory business (including how the adviser allocates investment opportunities).

Note that the proposed rule does not create a private right of action by the investor against the adviser - only the SEC would be able to bring an enforcement action for a violation of the proposed rule. The SEC also states in the Proposal that the proposed rule would not create a fiduciary duty to investors or prospective investors not otherwise imposed by law.

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<sup>10</sup> One court has held that section 206(4) of the Advisers Act does not require a showing of scienter and that a violation of section 206(2) of the Advisers Act could rest on a finding of simple negligence. *See, SEC v. Steadman*, 967 F.2d 636 (D.C. Cir. 1992), citing *Aaron v. SEC*, 446 U.S. 680 (1980).

<sup>11</sup> The SEC’s enforcement powers include the authority to (i) issue cease and desist orders to stop ongoing frauds, (ii) bar a person who has committed a violation from being associated with an investment adviser, (iii) impose civil penalties, (iv) seek federal court-imposed injunctions and restraining orders to protect fund assets and (v) order disgorgement of ill-gotten gains.

## II. Amendments to the Private Offering Rules Under the Securities Act – Proposed Rules 509 and 216

### 1. Legal and Factual Background

Under the exemption provided by section 4(2) of the Securities Act and Regulation D thereunder (“Regulation D”), privately offered securities are exempt from registration in accordance with section 5 of the Securities Act. Offerings of securities conducted in accordance with the “safe harbor” criteria set forth in Regulation D are considered nonpublic offerings that comply with the private offering exemption of section 4(2). Privately offered investment pools generally rely on rule 506 of Regulation D in the offering of their securities. Rule 506 permits offers and sales of securities to an unlimited number of “accredited investors” and up to 35 non-accredited investors without registering such securities under the Securities Act.

Rule 501(a) of Regulation D defines several categories of accredited investor.<sup>12</sup> Under rule 501(a), a natural person is an accredited investor if 1) that person’s individual net worth, or joint net worth with that person’s spouse, at the time of the purchase of a security, is \$1,000,000 or 2) that person has individual income that exceeds \$200,000 in each of the two most recent years or joint income with that person’s spouse in each of those years exceeds \$300,000, and there is a reasonable expectation of reaching the same income level in the current year.<sup>13</sup> The SEC notes in the Proposal that it adopted these net worth and income standards in 1982 based on its view that these tests would provide appropriate and objective standards to meet its goal of allowing investments in private offerings only by such persons who are capable of evaluating the merits and risks and of that investment.<sup>14</sup>

In the Proposal, the SEC noted that inflation, along with the sustained growth in wealth and income of the 1990’s, has boosted a substantial number of investors past the “accredited investor” standard. To protect such investors that may be investing in 3(c)(1) funds, the Proposal adds a second step to the accredited investor test to determine a natural person’s financial sophistication and ability to bear economic risk by taking into account the investor’s investment experience and market exposure.<sup>15</sup> As discussed below, a natural person would have to hold a substantial amount of “investments” under

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<sup>12</sup> Such investors include banks, savings and loan associations, registered broker dealers, registered investment companies, certain state sponsored employee benefit plans, non-profit organizations organized under section 501(c)(3) of the Internal Revenue Code with total assets exceeding \$5,000,000, certain natural persons, trusts with assets exceeding \$5,000,000 and entities in which all of the equity owners are accredited investors.

<sup>13</sup> Regulation D, rule 501(a)(5) and (6). Note that the SEC staff is also requesting comment on whether these thresholds should be increased.

<sup>14</sup> Securities Act Release No. 6389 (Mar. 8, 1982). *See, also*, Securities Act Release No 6758 (Mar. 3, 1988) (adopting \$300,000 joint income standard).

<sup>15</sup> Although investment experience and market exposure are not actually part of the proposed rules, it appears the SEC believes that the value of investments held by a natural person is an appropriate proxy for these qualities.

the proposed rules in order to be considered an “accredited natural person” and thus be eligible to invest in a 3(c)(1) fund.<sup>16</sup>

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

Proposed rules 509 and 216 would define a new category of accredited investor called “accredited natural person” that would apply to offers and sales of securities by 3(c)(1) funds to natural persons.<sup>17</sup> The proposed rules accomplish this by carving out an exception with respect to securities to be issued by a “private investment vehicle”. A “private investment vehicle” is a 3(c)(1) fund for purposes of the proposed rules.<sup>18</sup> The offer and sale of securities by venture capital funds would be specifically excluded from the application of the proposed rules. Furthermore, under the proposed rules, “accredited investor” is redefined with reference to natural persons investing in a private investment vehicle (i.e., a 3(c)(1) fund) to mean a natural person who meets the \$200,000 and \$300,000 income thresholds and/or the \$1,000,000 net worth threshold of the original accredited investor definition *and who owns (individually, or jointly with that person’s spouse (as further discussed below)) not less than \$2.5 million in “investments”*. The \$2.5 million threshold is subject to adjustment for inflation on April 1, 2012, and every five years thereafter.

## **3. Important Limitations on the Value and Scope of Investments for Purposes of the Proposed Rules**

The proposed test for natural persons is significant given that it would be considerably difficult for many natural persons to have sufficient “investments” to meet the \$2.5 million threshold. “Investments” would include securities<sup>19</sup>; real estate held for investment purposes; commodity interests held for investment purposes; physical

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<sup>16</sup> The proposed rules do not apply to 3(c)(7) funds. The SEC states in the Proposal that the investor protections that it believes are lacking with respect to 3(c)(1) funds already exist for 3(c)(7) funds, since natural persons who invest in such pools are required to own \$5 million in certain investments at the time of their investment and must also meet the definition of accredited investor. Accordingly, 3(c)(7) funds are already subject to a two-step approach that the SEC feels is adequate to ensure that investors in such funds have the requisite knowledge, sophistication and ability to bear the risk of their investment.

<sup>17</sup> Proposed rule 509 would modify the accredited investor definition for purposes of private offerings relying on the safe harbor of Regulation D, whereas proposed rule 216 would modify the definition of accredited investor for purposes of offerings under section 4(6) of the Securities Act. 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. The proposed definition of “accredited natural person” would be the same for purposes of Regulation D and section 4(6).

<sup>18</sup> Note that “private investment vehicle” is a more narrowly defined term than “pooled investment vehicle”. The latter term is broadly defined under proposed antifraud rule 206(4)-8 to cover several types of privately offered pools, including 3(c)(1) funds and 3(c)(7) funds. “Private investment vehicle” is narrowly defined under rules 509 and 216 to encompass 3(c)(1) funds only.

<sup>19</sup> Securities of issuers controlled by the investor are excluded for purposes of meeting the \$2.5 million threshold unless the issuer is a) an investment company (or would be an investment company but for the exclusions from that definition provided by 3(c)(1) through 3(c)(9) of the Company Act); b) a reporting company under section 13 or 15(d) of the Exchange Act or has a class of securities listed on a “designated offshore securities market” as defined under Regulation S under the Securities Act; or (c) a company with shareholders’ equity of not less than \$50 million.

commodities held for investment purposes; to the extent not securities financial contracts entered into for investment purposes and cash or cash equivalents. *Most notably, real estate would not be considered to be held for investment purposes by a prospective accredited natural person if it is used for personal purposes by such person (or a related person)<sup>20</sup> or as a place of business, or in connection with the conduct of trade or business of the prospective accredited natural person.* Thus, natural persons would not be able to count the value of their home toward the \$2.5 million threshold. Particularly for start-up funds, this represents a very significant change because it will reduce the population of eligible investors for such funds. We will be commenting to the SEC on this and other matters.

Furthermore, for purposes of valuing “investments”, the proposed rules would deduct the amount of any outstanding indebtedness incurred to acquire the investment owned by such person. The proposed rules also 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% 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.

#### **4. Additional Observations**

We note that the Proposal does not include a grandfather provision. This means that currently invested natural persons in private investment vehicles who no longer meet the definition of accredited investor upon enactment of the proposed rules would be allowed to maintain their existing investments but would not be able to make future investments in private investment vehicles, even those in which they are currently invested. The SEC also notes that private investment vehicles or their investment advisers may compensate their employees either by relying on certain offering exemptions under the Securities Act or through contractually based incentives linked to the performance of the investment vehicle. The SEC is soliciting comments on whether to subject such employees to the same proposed accredited natural person standard.

### **Analysis**

#### **I. Proposed Antifraud Rule**

We note with some concern a passage in the Proposal in which the SEC gives examples of where false or misleading statements might occur that would be actionable under the proposed rule.<sup>21</sup> False or misleading statements may be made, for example, *in account statements sent to existing investors* as well as to prospective investors in private placement memoranda, offering circulars, or responses to “requests for proposals.” Given the application of the rule to current and prospective investors and its inclusion of all statements made to such investors, this is indeed a broad rule, and we believe that it

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<sup>20</sup> A related person would mean a natural person who is 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 a spouse of such descendant or ancestor.

<sup>21</sup> Proposal, p.8.

would necessitate a review of all communications to current and prospective investors, including such routine communications as monthly NAV reports, to ensure that no statement contained therein could be deemed false or misleading. It may also necessitate inclusion of certain legends and disclaimers in such communications to avoid any doubt as to the nature of the statements made to investors. Advisers may incur additional costs due to this enhanced review of investor communications.

Certain other questions were not addressed in the Proposal. For example, there is no definitive standard for what constitutes a materially false or misleading statement; an innocent mistake in communications to current and prospective investors could lead to liability. The Proposal also does not make clear whether investment advisers would also be liable for statements made by third party service providers, solicitation agents, or other such entities to investors or prospective investors. We hope the SEC will address these questions during the comment period.

## **II. Proposed Rules Amending the Definition of Accredited Investor**

Advisers to 3(c)(1) funds will be particularly impacted by the proposed change to the definition of “accredited investor” in Regulation D and section 4(6) of the Securities Act. This is because many natural persons who previously qualified as accredited investors will not have sufficient investments to qualify under the newly proposed definition of “accredited natural person”. The SEC’s Office of Economic Analysis estimates that in 2003, 8.47% of U.S. households qualified for accredited investor status. In contrast, approximately 1.3% of U.S. households would qualify for accredited natural person status if the \$2.5 million test were incorporated into the private offering rules.

Enactment of these rules will have at least two consequences. First, as noted above, advisers to 3(c)(1) funds would be prohibited from accepting additional capital contributions from existing investors who have lost their accreditation under the new rule. Second, the SEC predicts that 3(c)(1) funds may have to reduce the management and incentive fees they charge to investors due to increased competition to locate and raise capital from the smaller base of qualified potential investors.

We question whether it is appropriate for the SEC to target only 3(c)(1) funds when there are other investment vehicles, such as start-up companies, operating companies that raise capital through private placements for risky ventures and venture capital funds, that pose an equal or greater investment risk to natural persons. We expect this, together with the choice of \$2.5 million as the qualifying threshold for investments held by natural person investors, to be the subject of significant debate during the comment period. Also certain to engender significant comment is the issue of whether and to what extent certain employees of private investment vehicles should be subject to the accredited natural person standard.

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Please note that the SEC is accepting comments on the proposed rules through March 9, 2007, and thus the Proposal is subject to change. If you wish to discuss the

Proposal with us or have any comments that you would like us to convey to the SEC, please do not hesitate to contact us.

January 17, 2007