SEC PROPOSES NEW ANTI-FRAUD RULE UNDER THE INVESTMENT ADVISERS ACT OF 1940 AND HIGHER "ACCREDITED INVESTOR" STANDARDS FOR NATURAL PERSONS WHO INVEST IN PRIVATE FUNDS

On December 27, 2006, the Securities and Exchange Commission proposed new rules to (1) specifically prohibit fraud by investment advisers, both registered and unregistered, on investors in pooled investment vehicles, and (2) revise the criteria for a natural person to be considered an "accredited investor" for the purpose of investing in certain private funds.[1] The proposals reflect the latest attempt by the SEC to regulate hedge fund managers after the decision in Goldstein v. SEC,[2] but the anti-fraud provisions would also apply to advisers to any investment company.

New Anti-Fraud Rule 206(4)-8 under the Advisers Act

Section 206(4) of the Investment Advisers Act of 1940 (the "Advisers Act") generally prohibits an investment adviser from engaging in any act, practice or course of business which is fraudulent, deceptive or manipulative. The hedge fund adviser registration rule, adopted on October 26, 2004, required an investment adviser to a private fund to consider the underlying investors of a private fund as clients for certain purposes.[3] In Goldstein v. SEC the U.S. Court of Appeals for the District of Columbia Circuit overturned that rule and cast doubt on the duties of an adviser to underlying investors under the Advisers Act.

The SEC is proposing new anti-fraud Rule 206(4)-8, which would explicitly prohibit certain activities with respect to the underlying investors or prospective investors in pooled investment vehicles. Proposed Rule 206(4)-8 would apply to all investment advisers to pooled investment vehicles, regardless of whether the adviser is registered under the Advisers Act.

A "pooled investment vehicle" for purposes of this proposed rule would include any investment company including *registered* investment companies and any company that would be an investment company but for one of the two exclusions under the Investment Company Act of 1940 (the "1940 Act") upon which hedge funds and private equity funds typically rely: Section 3(c)(1) - available to privately offered funds with 100 or fewer beneficial owners of their outstanding securities - or Section 3(c)(7) - available to privately offered funds all of whose

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[1] Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles; Accredited Investors in Certain Private Investment Vehicles, Release No. 33-8766; IA-2576: File No. S7-25-06 (the "Release"), available at http://www.sec.gov/rules/proposed.shtml.

[2] Goldstein v. Securities and Exchange Commission, 451 F.3d 873 (D.C. Cir. 2006). See also Willkie Farr & Gallagher LLP Client Memorandum, "U.S. Court of Appeals Overturns Hedge Fund Adviser Registration Rule" (June 23, 2006), available at http://www.willkie.com/firm/pubs.aspx.

[3] *See* Registration Under the Advisers Act of Certain Hedge Fund Advisers, Investment Advisers Act Release No. 2333 (Dec. 2, 2004), *available at* http://www.sec.gov/rules/final/ia-2333.htm.

securityholders are "Qualified Purchasers" (generally individuals or family companies with a $5 million investment portfolio or institutions with a $25 million investment portfolio). The proposed rule would make it a fraudulent, deceptive or manipulative act, practice or course of business in violation of Section 206(4) of the Advisers Act for an investment adviser to a pooled investment vehicle to make false or misleading statements or to otherwise defraud investors or prospective investors in that pool. The SEC notes that, unlike Rule 10b-5 under the Securities Exchange Act of 1934 which prohibits materially untrue or misleading statements *in connection with the purchase or sale of securities*, proposed Rule 206(4)-8 would prohibit advisers to pooled investment vehicles from making materially false or misleading statements to any investor or prospective investor in the pool regardless of whether the pool is offering, selling or redeeming securities. As an example, the Release states that the proposed rule would prohibit

> 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.

The SEC is also proposing to prohibit other fraudulent, deceptive or manipulative acts or practices with respect to investors or prospective investors in pooled investment vehicles by advisers to such vehicles that may not involve "statements".[4]

Furthermore, in any enforcement proceeding the SEC would not need to demonstrate that an adviser acted with *scienter* (intent to deceive, manipulate, or defraud) in order to establish a violation of Rule 206(4)-8. The SEC did note, however, that this new anti-fraud rule would not provide underlying investors with a private right of action under the Advisers Act.

Amendments to Accredited Investor Criteria Under the Securities Act

The SEC is also proposing new Rules 216 and 509 under the Securities Act of 1933 (the "Securities Act"). These rules would require a natural person investing in a private investment fund that relies upon the Section 3(c)(1) exemption from the 1940 Act and Regulation D or Section 4(6)[5] under the Securities Act, to be both an "accredited investor"[6] under the existing

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[4] See the Release, II.C. proposed Rule 206(4)-8(a)(2).

[5] Section 4(6) provides an issuer exemption for offers and sales of securities exclusively to accredited investors for offerings not exceeding $5 million which do not involve any general solicitation.

[6] Rule 501(a) under the 1933 Act currently defines an "accredited investor" in the case of a natural person to be an individual with a net worth of more than $1 million or with an income of more than $200,000 (or joint income of $300,000 for married couples) per year for the past two years and reasonably expected in the current year. "Net worth" for this definition includes the value of residences and personal assets.

standards *and* to own at least $2.5 million in "investments" on the date of investment.[7] Because the $2.5 million in investments part of this new "accredited natural person" standard would not include personal residences and certain other personal assets as contributing to a natural person's qualifying assets, many current investors in Section 3(c)(1) funds would no longer be "accredited investors" and may be precluded from making new investments, even in funds in which they are already invested. As under the current rules, a fund may continue to rely upon the provisions of Regulation D under the Securities Act and allow the sale of securities in any offering to up to 35 non-accredited investors, provided certain conditions are satisfied.[8] However, if the fund does not allow sales to non-accredited investors or has already sold to 35 non-accredited investors in a continuous offering, no additional sales could be made to natural persons not meeting the new standard.

The proposed rules would not apply to funds relying on Section 3(c)(7) of the 1940 Act, which requires investors to meet the higher investor thresholds noted above. The proposal specifically excludes "Venture Capital Funds" (defined to have the same meaning as "business development companies" in Section 202(a)(22) of the Advisers Act) from the new accreditation standard for natural persons. The $2.5 million threshold would be adjusted for inflation on April 1, 2012 and every five years thereafter.

Comment Requested

The SEC is soliciting comment on a number of issues concerning these proposals, including (1) whether the anti-fraud proposal should, like the "accredited natural person" standard, apply only to Section 3(c)(1) funds, (2) whether the new investor threshold is appropriate, (3) whether a "grandfathering" provision should be added so that persons currently invested in Section 3(c)(1) funds could make additional investments, (4) whether the exemption for and definition of Venture Capital Funds is appropriate, and (5) whether some type of exemption to allow "knowledgeable employees" to invest in Section 3(c)(1) funds should be included.

The deadline for commenting on these proposals is March 9, 2007.

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[7] The SEC has defined "investments" for this purpose in a manner similar to the corresponding term used in determining whether a person is a "Qualified Purchaser" for purposes of the Section 3(c)(7) exemption from the 1940 Act, with certain modifications.

[8] Regulation D provides for higher disclosure standards for offerings made to non-accredited investors. Additionally, while an offering not qualifying for Regulation D due to this new investor threshold might also be exempt from registration as a transaction "not involving any public offering" pursuant to Section 4(2) of the Securities Act, the preemption of state blue sky laws which provides for more uniform filing requirements would not be available for such an offering.

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