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SEC Proposes New Antifraud and Accredited Investor Requirements for Funds

On December 27, 2006, the Securities and Exchange Commission ("*SEC*") proposed new Rules to (1) prohibit advisers (whether or not registered) from making false or misleading statements to, or otherwise defrauding, investors or prospective investors in pooled investment vehicles (such as private equity funds and hedge funds) and (2) raise the threshold for natural persons to qualify as "accredited investors" in privately-offered pooled investment vehicles.[1] The proposed antifraud Rules are in response to the D.C. Court of Appeals' decision in *Goldstein v. SEC*,[2] which vacated the SEC's proposed hedge fund adviser registration Rule.

Comments on the proposed rules should be received by the SEC on or before March 9, 2007.

I. NEW ANTIFRAUD RULE FOR FUND ADVISERS

Proposed Rule 206(4)-8 under the Investment Advisers Act of 1940 (the "*Advisers Act*") would be a new antifraud rule covering statements or omissions by an adviser (whether or not registered) to an investor or potential investor in a "pooled investment vehicle." Although the proposed rule's legal standard would be the same as that contained in Rule 10b-5 under the Securities Exchange Act of 1934, the proposed rule would not (unlike Rule 10b-5 and other similar antifraud rules) be limited to statements and omissions "in connection with the purchase and sale of securities." Rather, Rule 206(4)-8(a)(1) would apply "regardless of whether the pool is offering, selling or redeeming securities." Thus, the proposed rule could cover statements or omissions in account statements or letters to investors. Moreover, the proposed rule is not limited to disclosure and would apply to any fraudulent, deceptive or manipulative conduct (which could include, for example, valuation or operating practices).

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1 *See* Securities Act of 1933 Release No. 33-8766, entitled "Prohibition of Fraud by Advisers to Certain Investment Vehicles; Accredited Investors in Certain Private Investment Vehicles," *available at* http://www.sec.gov/Rules/proposed/2006/33-8766.pdf (Dec. 27, 2006).

2 451 F.3d 873 (D.C. Cir. 2006). *See* our prior firm memo, "SEC Hedge Fund Rule Vacated in *Goldstein v. SEC*" (June 27, 2006).

For purposes of the proposed rule, a "pooled investment vehicle" would include any issuer that is a registered investment company or that would be required to register but for the exclusions in section 3(c)(1) (privately offered vehicles with no more than 100 beneficial owners) ("*3(c)(1) Funds*") or section 3(c)(7) (privately offered vehicles held exclusively by "qualified purchasers") ("*3(c)(7) Funds*") of the Investment Company Act of 1940 (the "*Investment Company Act*"). Thus, the proposed rule generally would apply to advisers to hedge funds, private equity funds and venture capital funds, but not to advisers to vehicles that rely on other exemptions from registration (such as business development companies, mortgage REITs, or structured finance vehicles).

Although the SEC has proposed that enforcement be limited to SEC administrative and civil actions, without creating a private right of action, the proposed rule would not require the SEC to show that the adviser intentionally (or even knowingly) violated the Rule.

II. "ACCREDITED NATURAL PERSONS"

The other set of proposed rules would raise the accreditation threshold for natural persons who invest in 3(c)(1) Funds. Such funds typically are offered to investors in private offerings that are not registered under the Securities Act of 1933 (the "*Securities Act*"), based on the safe harbor provided by Regulation D under the Securities Act or the more general statutory exemption afforded by section 4(2) of the Securities Act.[3] Regulation D permits offerings to "accredited investors," which, in the case of natural persons, currently includes individuals (there are separate tests for entities) with annual income in excess of $200,000 (or joint income with such person's spouse of $300,000) or a personal net worth (or joint net worth with such person's spouse) of $1 million. The SEC's proposed Rule 509 under the Securities Act would require individuals ("*accredited natural persons*") investing in a 3(c)(1) Fund (other than a U.S. venture capital fund) to satisfy the existing Regulation D income or net worth tests and, in addition, own $2.5 million of "investments" in order to be considered an "accredited investor" under Regulation D.

3(c)(7) Funds would not be subject to the new Rule, because natural persons investing in 3(c)(7) Funds must generally own $5 million of investments (as defined in Rule 2a51-1 under the Investment Company Act).

The proposed rule's definition of "investments" is based on, but narrower than, the present definition in Rule 2a51-1. The proposed rule:

- would include only 50% of investments that are community property or other jointly held or shared ownership interests with the investor's spouse, if the investor seeks to invest individually (where spouses invest jointly, the full value of all investments, whether held jointly or individually, would be included);

[3] If the proposed rule is adopted, 3(c)(1) Funds relying on section 4(2), but not Regulation D, may choose to consider the "accredited natural person" standard for individual investors, even though not required to do so under section 4(2).

- would value the investments based on their fair market value, calculated on a per investment basis (Rule 2a51-1 determines the value of investments based on either fair market value or cost);

- would periodically adjust the $2.5 million threshold for inflation; and

- like Rule 2a51-1, would exclude real estate that is not held for investment purposes (such as real estate used as a personal residence or place of business).

3(c)(1) Funds would continue to be able to rely on Rule 506 under the Securities Act (which permits private sales to up to 35 non-accredited investors) or section 4(2) of the Securities Act (which permits private placements generally, albeit without the bright-line protection that the Regulation D safe harbor provides) for unregistered offerings, but would be subject to the limitations or uncertainty of those routes.

Investors in existing 3(c)(1) Funds who are accredited investors but would not qualify as accredited natural persons under the new Rules would not be grandfathered for purposes of new investments that they might make in the fund. The proposed rules do not contain any exceptions specifically allowing investment by employees of the fund's manager who do not meet the new criteria.[4] The SEC noted that in addition to the continued availability of the general exemptions from registration described in the preceding paragraph (which are available to all potential investors), employees also could invest in compliance with Rule 701 under the Securities Act (which exempts securities offerings pursuant to certain compensatory benefit plans and compensation contracts) or pursuant to the practice of allocating a portion of the vehicle's interest in the performance fee, or "carry," payable to the vehicle, to its employees.

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If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or e-mail Jonathan I. Mark at (212) 701-3100 or jmark@cahill.com; or Sidney Burke at (212) 701-3196 or sburke@cahill.com.

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[4] The SEC requests comments as to whether it should add certain "knowledgeable employees" as defined in Rule 3c-5 under the Investment Company Act to the list of "accredited natural persons."