KAYE SCHOLER LLP

INVESTMENT FUNDS GROUP

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SEC Publishes Text of New Rules for Hedge Fund and Private Equity Fund Advisers

By Timothy Spangler

The Securities and Exchange Commission (the "SEC") has published the text of its proposed new rules for advisers to hedge funds and private equity funds. First, the SEC is proposing to adopt a new antifraud rule under the Investment Advisers Act of 1940 (the "Advisers Act") that would clarify, in light of the recent court decision in *Goldstein v. SEC*, 451 F.3d 873 (D.C. Cir. 2006), the ability of the SEC 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, they are proposing a rule that would revise the requirements for determining whether an individual is eligible to invest in certain pooled investment vehicles. This would be accomplished by defining 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.

ANTIFRAUD PROVISION

The *Goldstein* decision, in addition to overturning the SEC's rules adopted in 2004 mandating registration under the Advisers Act for several hundred hedge fund managers, created uncertainties regarding the obligations that investment advisers to funds have to the funds' investors.

In addressing the scope of the exemption from registration in section 203(b)(3) of the Advisers Act and the meaning of "client", the court expressed the view that, for purposes of sections 206(1) and (2), the "client" of an investment adviser managing a fund is the fund itself, not the investors in the fund. 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 fund are defrauded by an investment adviser.

The *Goldstein* decision did not, however, call into question the SEC's authority to adopt rules under section 206(4) of the Advisers Act, which permits the SEC to adopt rules proscribing fraudulent conduct that is potentially harmful to investors who directly or indirectly invest in hedge funds and other types of pooled investment vehicles.

Proposed rule 206(4)-8, therefore, would prohibit advisers to investment companies and other pooled investment vehicles from (i) making false or misleading statements to investors in pooled investment

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vehicles, or (ii) otherwise defrauding them. The SEC would enforce the rule through administrative and civil actions against advisers under section 206(4) of the Advisers Act. There would be no private cause of action against an adviser under the proposed rule.

Any investment adviser to a pooled investment vehicle would be covered by the rule, including advisers who are not registered or required to be registered under the Advisers Act. The proposed rule would not distinguish among types of pooled investment vehicles and is designed to protect investors both in investment companies and in funds that are excluded from the definition of investment company under section 3(a) of the Investment Company Act of 1940 (the "Company Act") by reason of either section 3(c)(1) or 3(c)(7) of the Company Act.

The wording of the proposed rule, which is similar to that in many of the SEC's other antifraud rules, prohibits false or misleading statements of material facts by investment advisers. Unlike rule 10b-5 under the Exchange Act of 1934 and other rules that focus on securities transactions, however, rule 206(4)-8 would not be limited to fraud in connection with the purchase and sale of a security. Accordingly, proposed rule 206(4)-8(a)(1) would prohibit advisers from making any materially false or misleading statements to investors in the fund regardless of whether the fund is offering, selling, or redeeming securities.

As a result, the proposed rule would cover a wide range of potential communications to both existing investors and prospective investors, including:

* statements regarding the investment strategy of the fund;

* the experience and credentials of the advisor and its principals;

* risks associated with the fund;

* the performance of the fund or other funds advised by the adviser;

* the valuation of the fund and its investments.

Private placement memoranda, requests for proposals, account statements and any other form of communication would be covered by the proposed rules on an ongoing basis.

Importantly, however, 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.

ACCREDITED INVESTOR DEFINITION

The SEC also proposed two new rules under the Securities Act of 1933 (the "Securities Act"). 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 section 3(c)(1) exempt funds (defined in the proposed rules as "private investment vehicles") to accredited investors under Regulation D and section 4(6).

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. 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.

Otherwise, 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. Non-accredited natural persons could still purchase interests in such a fund under the provisions that permit up to 35 non-accredited investors to participate in such offerings. In practice, however, many funds refuse to accept non-accredited investors into their funds.

The proposed rules would apply solely to the offer and sale of securities issued by private investment vehicles, which are defined 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. 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.

Importantly, existing fund investors who do not meet the new "accredited natural person" standard would not be eligible to make further investments in the fund. This could create significant problems for funds with undrawn capital commitments still outstanding.

Section 3(c)(7) exempt funds are not included within the definition of private investment vehicle because offers and sales of securities issued by 3(c)(7) funds 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.

According to statistics provided to the SEC, in 1982, when Regulation D was adopted, approximately 1.87% of U.S. households qualified for accredited investor status. 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.

The proposed rules specifically would not apply to the offer and sale of securities issued by certain venture capital funds, which are defined as having the same meaning as the definition of business development company in section 202(a)(22) of the Advisers Act. Among other things, a business development company must be organised and have its principal place of business in the US, and must invest at least 60% of its assets in small US companies. The term business development company is also defined in section 2(a)(48) of the Company Act, albeit more narrowly. The SEC has requested comment on (among other things) whether defining venture capital fund with reference to the definition provided in the Advisers Act is appropriate, as opposed to the definition provided in the Company Act or in terms of their investment objective and strategy (*e.g.*, investing in and developing start-up and early phase businesses).

The comment period closes on March 9, 2007.