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CLIENT ADVISORY

SEC Proposed New Rules to Affect Hedge Funds

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On December 27, 2006, the Securities and Exchange Commission (the "SEC") published proposed new rules that it had first voted to propose on December 13, 2006, which would impact investments in pooled investment vehicles such as hedge funds, private equity funds and venture capital funds. The new rules would (1) amend the private offering "safe harbor" rules under the Securities Act of 1933, as amended (the "Securities Act"), to require individual investors in certain pooled investment vehicles to own at least $2.5 million in investments in addition to the current net worth or annual income requirements and (2) prohibit advisers to funds (or other pooled investment vehicles) from making false, misleading or deceptive statements or acts. The SEC has established a comment period for these rules ending March 9, 2007.

PROPOSED RULES 509 AND 216: AUGMENTED INVESTOR REQUIREMENTS

Background to Proposed Rule 509 and 216

The SEC aims to shield less sophisticated investors from the perceived growing complexity and risk associated with pooled investment vehicles by expanding the requirements individuals must meet to invest in these funds. In recent years, the SEC and government officials have expressed concern that increases in inflation, income and residential home prices since the SEC adopted Regulation D under the Securities Act in 1982 have qualified a substantial number of people to invest in certain pooled investment vehicles. Accordingly, the SEC believes that additional investor protections may be appropriate to provide assurance that an investor has a level of knowledge, financial sophistication and the ability to bear the economic risk of the investment in a pooled investment vehicle.

Section 4(2) of the Securities Act, exempts "transactions by an issuer not involving a public offering" from the registration and prospectus delivery requirements of Section 5 of the Securities Act. To clarify this exemption, the SEC adopted Regulation D under the Securities Act to establish certain "safe harbor" criteria, including Rule 506 of Regulation D which allows privately offered investment pools to sell securities to an unlimited number of "accredited investors" without

Washington, DC
+1 202.942.5000

New York
+1 212.715.1000

London
+44 (0)20 7786 6100

Brussels
+32 (0)2 517 6600

Los Angeles
+1 213.243.4000

San Francisco
+1 415.356.3000

Northern Virginia
+1 703.720.7000

Denver
+1 303.863.1000

registration. Rule 501(a) of Regulation D defines "accredited investor" to be a natural person whose individual net worth, or joint net worth with the person's spouse, exceeds $1 million at the time of the purchase, or whose individual income exceeds $200,000 (or joint income with the person's spouse exceeds $300,000) in each of the two most recent years and who has a reasonable expectation of reaching the same income level in the year of investment. It should be noted that failure to satisfy the requirements of Regulation D does not prevent issuers from having a private placement; it merely prevents such an issuer from benefiting from Regulation D's safe harbor.

Similar to the Rule 506 safe harbor, a pooled investment vehicle can take advantage of exemptions from registration as an investment company under the Investment Company Act of 1940, as amended (the "Investment Company Act"). A pooled investment vehicle relying on the exemption found in Section 3(c)(1) of the Investment Company Act (a "3(c)(1) Fund") may be owned by not more than 100 investors of which no more than 35 may be unaccredited investors. In contrast, investors in a pooled investment vehicle which is excluded from the definition of an investment company pursuant to the exemption found in Section 3(c)(7) of the Investment Company Act (a "3(c)(7) Fund") must meet the more rigorous "qualified purchaser" standard requiring natural persons who invest in such pools to own $5 million in certain investments at the time of their investment in addition to qualifying as accredited investors. The proposed rules would bring the requirements to invest in a 3(c)(1) Fund closer to those required to invest in a 3(c)(7) Fund.

Proposed Rule 509 and 216

Proposed Rule 509 augments the net worth requirements of investors seeking to invest in 3(c)(1) Funds whereas proposed Rule 216 provides a parallel exemption for offerings under $5 million made pursuant to the exemption provided for by Section 4(6) of the Securities Act. These rules would apply solely to the offer and sale of securities issued by certain 3(c)(1) Funds to be defined as "private investment vehicles" that rely on the safe harbor provisions of Regulation D or Section 4(6) of the Securities Act. Funds qualifying as venture capital funds are specifically excluded from the definition of private investment vehicle and therefore are not affected by the proposed rules.

The proposed rules create a new category of accredited investor dubbed an "accredited natural person" which includes any natural person who at the time of purchase of securities (1) meets the definition of accredited investor pursuant to Rule 501(a), as it relates to natural persons, and (2) owns (individually, or jointly with the person's spouse) not less than $2.5 million (as adjusted every five years for inflation) in investments excluding primary residences and real estate held in connection with a trade or business.

For the purposes of determining whether a natural person qualifies as an accredited natural person, the proposed definition of "investments" is based on the existing definition set forth in Rule 2a51-1 under the Investment Company Act. One notable difference, however, is the manner in which investments are calculated for married persons. Under the proposed rules a natural person's investments would be deemed to include only fifty percent (50%) of (1) any of such person's investments held jointly with a spouse; and (2) any investment in which the natural person shares a community property or similar shared ownership interest with a spouse. Where both spouses make a joint investment in a private investment vehicle, the full amount of all their investments may be included for the purposes of determining whether each spouse is an accredited natural person.

Persons currently deemed to be accredited investors would not be able to make future investments in affected funds, even in those funds in which the investor is currently invested, unless the investor meets the new heightened accredited natural person standard. Moreover, as noted above, the proposed rules call for the $2.5 million threshold to be adjusted for inflation every five years, with the first adjustment scheduled for April 2012. As such, these proposed rules will have no effect on 3(c)(7) Funds.

PROPOSED RULE 206(4)-8: INVESTOR ANTIFRAUD PROTECTIONS

Background to Proposed Rule 206(4)-8

Rule 206(4)-8 is being proposed in the wake of the opinion in *SEC v. Goldstein*[1], where the court invalidated the requirement that hedge fund advisers register as investment advisers under the Investment Advisers Act of 1940, as amended (the "Investment Advisers Act"). *Goldstein* cast doubt on whether investors in a pool are sufficiently protected from advisers that commit fraudulent or deceptive acts by the existing antifraud provisions of Sections 206(1) and 206(2) of the Investment Advisers Act.

Proposed Addition of Regulation under Rule 206(4)-8

The SEC has proposed Rule 206(4)-8 to the Investment Advisers Act. This rule would make it illegal for advisers to pooled investment vehicles, including advisers that are not registered or required to be registered under the Investment Advisers Act, to defraud investors or potential investors by (1) making false or misleading statements, or (2) otherwise defrauding investors. Among other things, this rule would make it illegal for such advisers to make materially false or misleading statements, or to omit to state a material fact, regarding the adviser's current or future investment strategies, associated risks, past performance, valuation, credentials, or the adviser's business practices such as the allocation of investment opportunities.

As noted above, the proposed rule would apply to all fund advisers, regardless of whether such advisers are registered or required to be registered as investment advisers under the Investment Advisers Act. The proposed rule is designed to protect investors in 3(c)(1) Funds and 3(c)(7) Funds, as the SEC believes that most of the pooled investment vehicles privately offered to investors fit into one of the two categories. This would include most pooled investment vehicles such as hedge funds, private equity funds, venture capital funds and other types of privately or publicly offered pools that invest in securities, regardless of the investment strategy or the fund's structure. Under the proposed rule, it would constitute a fraudulent, deceptive or manipulative act, practice or course of business for an adviser to a pooled investment vehicle to make any untrue statement of a material fact to any investor or prospective investor in such investment vehicle, or to omit to state a material fact necessary in order to make the statements made to any investor or prospective investor, in light of the circumstances under which the statements were made, not misleading. Unlike other existing antifraud rules such as Rule 10b-5 of the Securities Exchange Act of 1934, as amended, the proposed rule is not limited to fraud in connection with the purchase and sale of a security nor does it necessitate that an adviser intend to mislead investors for such adviser be found in violation of the rule. Further, the proposed rule does not permit individual investors to bring private suits against advisers; rather the SEC would be responsible for bringing all causes of action pursuant to the proposed rule.

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These rules were proposed in response to the political clamor to "do something" about hedge funds and their growing clout, particularly after *Goldstein* invalidated the SEC's requirement that hedge fund advisers register. Coming prior to hearings expected to be conducted in the new Congress, the SEC can now say that it has in fact done something. These proposals, however, are far more modest than the SEC's earlier attempt to regulate the hedge fund industry by forcing it to register under the Investment Advisers Act.

1 451 F.3d 873 (D.C. Cir. June 23, 2006).

We hope you find this summary useful. Upon request, we will provide a copy of the proposal issued by the SEC. We are happy to assist you in understanding the proposed rules and in preparing comments to be submitted to the SEC. If you would like more information about regulatory issues facing pooled investment vehicles, please contact

Michael F. Griffin
+1 212.715.1136
Michael.Griffin@aporter.com

Richard P. Swanson
+1 212.715.1179
Richard.Swanson@aporter.com

David F. Freeman
+1 202.942.5745
David.Freeman@aporter.com

J.P. Bruynes
+1 212.715.1135
JP.Bruynes@aporter.com

Rob Holton
+1 212.715.1137
Robert.Holton@aporter.com

William V. de Cordova
+1 212.715.1020
William.deCordova@aporter.com