The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

MEMO# 20772

January 9, 2007

SEC Proposes New Rules Prohibiting Fraud by Investment Advisers to Pooled Investment Vehicles and Defining New Category of Accredited Investor; January 16th Conference Call

[20772]

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TO: SEC RULES COMMITTEE No. 3-07
CLOSED-END INVESTMENT COMPANY COMMITTEE No. 1-07
INVESTMENT ADVISERS COMMITTEE No. 1-07
SMALL FUNDS COMMITTEE No. 1-07 RE: SEC PROPOSES NEW RULES PROHIBITING FRAUD BY INVESTMENT ADVISERS TO POOLED INVESTMENT VEHICLES AND DEFINING NEW CATEGORY OF ACCREDITED INVESTOR; JANUARY 16TH CONFERENCE CALL

The Securities and Exchange Commission recently published for comment a new rule, Rule 206(4)-8 under the Investment Advisers Act of 1940, which would prohibit advisers to "pooled investment vehicles" from defrauding investors or prospective investors in those vehicles. At the same time, the SEC published for comment two rules that would create a new category of accredited investor for natural persons investing in any issuer that would be an investment company but for the exclusion provided in Section 3(c)(1) of the Investment Company Act ('private investment vehicle"). [1] The Release is summarized below.

Comments on the Release are due to the SEC by March 9, 2007. The Institute will be having a conference call to discuss the Release and the Institute's comments thereon on Tuesday, January 16th at 2:00 EST. If you plan on participating on the call, please let

Barbara Watkins know via email (bwatkins@ici.org) as soon as possible but no later than March 8th. If you are unable to participate on the call but have comments on the Release, please provide them prior to the call to Dorothy Donohue by phone (202-218-3563), email (ddonohue@ici.org), or fax (202-326-5827). The dial-in number for the call is 800-369-1764 and the pass code is 21376.

Rule 206(4)-8 under the Advisers Act

According to the Release, the SEC is proposing Rule 206(4)-8 to clarify, in light of a recent court decision, the SEC's ability to bring enforcement actions under the Advisers Act against investment advisers who defraud investors in hedge funds or other pooled investment vehicles. [2] Rule 206(4)-8 would prohibit advisers to investment companies and other pooled investment vehicles from making any material misstatements or omissions to any current or prospective investor in the pooled investment vehicle.

The proposed rule would apply to any adviser to a pooled investment vehicle, including advisers that are not registered or required to be registered with the SEC. Under the proposal, "pooled investment vehicles" would include investment companies as defined in Section 3(a) of the Investment Company Act or any company that would be an investment company under Section 3(a) but for Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act. The Release requests comment on whether companies excluded from the definition of investment company by other provisions in Section 3(c) of the Investment Company Act should be covered by the proposed rule. It also requests comment on whether certain advisers to pooled investment vehicles should not be subject to the proposed rule and why such an exemption would be appropriate.

The Release states that, unlike Rule 10b-5 under the Securities Exchange Act of 1934, Rule 206(4)-8 would not be limited to fraud committed in connection with the purchase and sale of a security, and the SEC would not be required to demonstrate that an adviser violating Rule 206(4)-8 acted with scienter. The Release explains that the proposed rule would prohibit, for example, materially false and misleading statements regarding the investment strategies that the pooled investment vehicle will pursue, the experience and credentials of the adviser, the performance of the pooled investment vehicle or other funds advised by the adviser, the valuation of the pooled investment vehicle, and the practices that the adviser follows in the operation of its advisory business, such as how the adviser allocates investment opportunities. [3] The Release also states that there would be no private cause of action against an adviser under Rule 206(4)-8.

Proposed Rule 206(4)-8(a)(2) also would make it a fraudulent, deceptive, or manipulative act for any adviser to a pooled investment vehicle to "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 the pooled investment vehicle." The Release states, without further explanation, that this is meant to apply to deceptive conduct that may not involve statements.

The Release states that proposed Rule 206(4)-8 would not create a fiduciary duty to investors or prospective investors in a pooled investment vehicles that is not otherwise imposed by law.

Proposed Rules 509 and 216 under the Securities Act

Proposed Rules 509 and 216 would limit offers and sales of securities issued by private investment vehicles under Section 4(6) of, and Regulation D under, the Securities Act of 1933 to natural persons who meet the new definition of "accredited natural persons." An accredited natural person would be any natural person: (i) whose individual net worth, or joint net worth with his or her spouse, exceeds $1,000,000 at the time of purchase; or (ii) whose individual income exceeds $200,000 (or joint income with his or her 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; and (iii) who owns individually, or jointly with his or her spouse, at least $2.5 million in "investments." [4] According to the Release, the proposed definition is meant to provide an objective and clear standard to use in ascertaining whether a purchaser of a private investment vehicle's securities is likely to have sufficient knowledge and experience in financial and business matters to enable that purchaser to evaluate the merits and risks of a prospective investment, or to hire someone who can.

The Release requests comment on whether the proposed requirement is appropriate and whether the net worth and income criteria applicable to natural persons investing in private investment vehicles should be increased or decreased. The Release also requests comment on whether employees of private investment vehicles or their investment advisers should be subject to the same accredited natural person standard or whether certain "knowledgeable employees" should be added to the list of accredited natural persons (consistent with Rule 3c-5 under the Investment Company Act). [5]

The proposed rules would not apply to the offer and sale of securities by venture capital funds. The term "venture capital fund" would have the same meaning as "business development company" in Section 202(a)(22) of the Investment Advisers Act. The Release explains that the exclusion for venture capital funds is being provided in recognition of the benefit that these funds play in the capital formation of small businesses. The SEC requests comment on whether this, or some other definition of venture capital fund, is appropriate, and whether the definition should be modified to include venture capital funds that invest a significant amount of their assets in foreign securities and other private pools.

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endnotes

[1] See SEC Release Nos. 33-8766, IA-2576 (December 27, 2006), 72 FR 399 (January 4, 2007) (“Release”). The Release is available on the SEC’s website at http://www.sec.gov/rules/proposed/2006/33-8766.pdf.

[2] Goldstein v. Securities and Exchange Commission, 451 F.3d 873 (D.C. Cir 2006) (“Goldstein”). In that decision, the court expressed the view that, for purposes of Sections 206(1) and 206(2) of the Advisers Act, the “client” of an adviser managing a pool is the pool itself, not investors in the pool. This statement has created some uncertainty regarding the application of Sections 206(1) and 206(2) in certain cases where investors in a pool are defrauded by the pool’s investment adviser.

[3] The Release states that prior to the Goldstein decision, advisers operated with the understanding that the Advisers Act prohibited the same conduct that would be prohibited by the proposed rule and that, accordingly, the SEC does not believe that advisers to pooled investment vehicles would need to take steps to alter their business practices in such a way that would require them to incur new or additional costs as a result of the adoption of the proposed rule.

[4] Investments are defined, in part, to exclude the value of real estate used for personal purposes or as a place of business.

[5] The Release notes that private investment vehicles that want to offer and sell their interests to employees may do so: (i) in reliance on Rule 506, which allows for 35 non-accredited investors, provided that certain conditions are met; (ii) by making an offering pursuant to Section 4(2); or (iii) in reliance on Rule 701 under the Securities Act, which provides an exemption from registration for offers and sales of securities to certain natural persons pursuant to certain compensatory benefit plans and contracts relating to compensation.
