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SEC Proposes Two New "Hedge Fund" Rules

At a U.S. Securities and Exchange Commission ("SEC") open meeting held on December 13, 2006, the SEC met to discuss a variety of issues related to the securities markets. This update examines one of these issues: the proposed hedge fund rules, which would actually affect many funds that otherwise would not be considered hedge funds.

In the course of the meeting, the SEC unanimously approved proposing a new rule under Section 206 of the Investment Advisers Act of 1940 ("Advisers Act") to address fraud in pooled investment vehicles ("Anti-Fraud Rule") and proposing a new rule under the Securities Act of 1933 ("1933 Act") to redefine "accredited investor" for the purpose of investing in some, but not all, privately offered investment vehicles (the "Accredited Natural Person Rule").[1] On December 27, 2006, the SEC released its proposed rules for public comment. The comment period for these proposed rules will close on March 9, 2007.[2]

The Anti-Fraud Rule

The proposed Anti-Fraud Rule under the Advisers Act would make it a fraudulent, deceptive, or manipulative act, practice, or course of business (and thus prohibited under Section 206 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.[3] The rule would apply to all investment advisers to pooled investment vehicles, regardless of whether the adviser is registered under the Advisers Act. Under the proposed rule, a pooled investment vehicle would include any investment company and any company that would be an investment company but for the exclusions in Sections 3(c)(1) and 3(c)(7) of the Investment Company Act of 1940 ("Investment Company Act").[4]

1 Press Release, United States Securities and Exchange Commission, SEC Votes to Propose Rule to Prohibit Fraud by Investment Advisers to Certain Pooled Investment Vehicles; Also Votes to Propose Revisions to Criteria for Accredited Investors in Certain Private Investment Vehicles (Dec. 13, 2006), *available at* http://www.sec.gov/news/press/2006/2006-208.htm.

2 Prohibition of Fraud by Investors to Certain Pooled Investment Vehicles; Accredited Investors in Certain Private Investment Vehicles, SEC Release No. IA-2576 (Dec. 27, 2006)("Proposing Release").

3 Proposed Rule 206(4)-8 under the Advisers Act.

4 A 3(c)(1) fund qualifies for the exclusion if it has not more than 100 investors and is not making or proposing to make a public offering. A 3(c)(7) fund qualifies for the exclusion if, among other things, it is not making or proposing to make a private offering and its outstanding securities are held by persons who are "qualified purchasers" when they acquired those securities. "Qualified purchasers" include any natural person owning at least $5 million in investments, a trust not specifically formed for the purpose of investing in the 3(c)(7) company and of which the trustee or other person authorized to make investment decisions and settlor is a qualified purchaser, and any other person or company that owns or invests on a discretionary basis at least $25 million in investments. Investment Company Act Section 2(a)(51)(A).

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Background[5]

The SEC's proposed rulemaking follows the U.S. Court of Appeals for the District of Columbia Circuit case, *Goldstein v. SEC*, in which the court vacated the SEC's attempt to require certain hedge funds to register with the SEC under the Advisers Act.[6] Registration was intended to bring more advisers to hedge funds under SEC regulation, and it was accomplished through the redefinition of "client" for purposes of the "private adviser exemption" under the Advisers Act.[7] Under the prior regulatory regime, the SEC had, by rule, defined the collective vehicle, rather than its owners, as the client for the purposes of registration.[8]

The court read the investment adviser's fiduciary obligations to private fund investors under the Advisers Act narrowly, stating that the fiduciary obligation of a hedge fund manager runs to the fund and not necessarily to the individual investors in the fund. The court asserted that the SEC's "interpretation of the word 'client' comes close to violating the plain language of the statute. At best it is counterintuitive to characterize the investors in a hedge fund as the 'clients' of the adviser. . . . The adviser owes fiduciary duties only to the fund, not the fund's investors."[9] The court concluded that "[t]he [SEC] has, in short, not adequately explained how the relationship between hedge fund investors and advisers justified treating the former as clients of the latter."[10]

The court's ruling brought into question the applicability of sections 206(1) and 206(2) of the Advisers Act to hedge fund advisers; however, the court did not address the applicability section 206(4).[11] Thus, the SEC decided to rely on section 206(4) of the Advisers Act and on its mandate to protect investors, in proposing its new Anti-Fraud Rule. With the new Anti-Fraud Rule, the SEC is attempting "to restore [its] enforcement powers"[12] in the hedge fund investment space following the *Goldstein* opinion.

The New Anti-Fraud Rule

As stated above, the proposed Anti-Fraud Rule would make it a violation of the Advisers Act for an investment adviser to make false or misleading statements to investors or prospective investors in a hedge fund. The rule would apply to registered and non-registered investment advisers alike. Furthermore, the proposed rule lacks a scienter requirement and therefore would impose a low negligence threshold for liability.

The proposed Anti-Fraud Rule does not give rise to a private right of action. Nonetheless, the Proposing Release states that "[p]roposed rule 206(4)-8(a)(2) would make it a fraudulent, deceptive, or manipulative act, practice, or course of business for any investment 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

5 For additional background information, *see* Dechert OnPoints: *SEC Releases Staff Report on Hedge Funds* (Oct. 23, 2003); *The SEC Proposal to Register Hedge Fund Advisers* (Aug. 2004); *The U.S. SEC Adopts Rules to Require Hedge Fund Advisers to Register* (Oct. 27, 2004); *The SEC Publishes Final Rule Requiring Hedge Fund and Certain Other Private Fund Advisers to Register* (Jan. 2005); *SEC Staff Issues Guidance on New Hedge Fund Adviser Registration Rule* (Dec. 2005); and *SEC Issues Guidance on Hedge Fund Adviser Rule* (Feb. 2006), *available at* http://www.dechert.com/practiceareas/practiceareas.jsp?pg=legal_update&pa_id=19.

6 *Goldstein v. SEC*, 451 F.3d 873 (D.C.Cir. 2006). *See also* Dechert OnPoint: *Court Overturns SEC Hedge Fund Rule* (June 2006).

7 Registration Under the Advisers Act of Certain Hedge Fund Advisers, SEC Release No. IA-2333 (Dec. 10, 2004) ("Adopting Release").

8 *See* Section 203(b)(3) of the Advisers Act and accompanying rules.

9 451 F.3d at 881.

10 *Id.* at 882.

11 Section 206(1) makes it unlawful for any adviser to "employ any device, scheme, or artifice to defraud any client or prospective client." Section 206(2) makes it unlawful for any adviser to "engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client. Section 206(4) makes it unlawful for any adviser to "engage in any act, practice, or course of business which is fraudulent, deceptive, or manipulative" and that "[t]he Commission shall for purposes of [paragraph 206(4)] by rules and regulations define, and prescribe means reasonably designed to prevent, such acts, practices and courses of business as are fraudulent, deceptive, or manipulative."

12 Annette Nazareth, Commissioner, United States Securities and Exchange Commission, Comments during the open meeting (Dec. 13, 2006).

investment vehicle.' The language of this provision is drawn from the first sentence of section 206(4) and is designed to apply more broadly to deceptive conduct that may not involve statements."[13]

At the SEC open meeting, several of the Commissioners appeared to be uncomfortable with the fact that the proposed Anti-Fraud Rule does not delimit any *per se* frauds, making each investment adviser fraud claim under the proposed rule a case-by-case factual inquiry. Commissioner Roel Campos disagreed with the regulatory approach of the rule, noting that it "does not impose a specific ongoing disclosure obligation" on investment advisers.

Commissioner Paul Atkins questioned the staff on possible *per se* fraud such as the failure to disclose so called "side letters" that provide certain investors with special treatment. However, the SEC staff members maintained that they had consciously not included substantive regulation in the proposed new rule in an effort to deny would-be defrauders a roadmap for circumventing the regulation.[14]

The Accredited Natural Person Rule

In addition to approving for publication the proposed Anti-Fraud Rule for hedge funds, the SEC also unanimously approved for release a proposed rule under the Securities Act of 1933 that would redefine "accredited investor" as it applies to natural persons investing in private investment vehicles other than certain venture capital funds, including hedge funds, relying on the Section 3(c)(1) exclusion from the definition of "investment company" under the Investment Company Act (the "Accredited Natural Person Rule").

The proposed Accredited Natural Person Rule was published in conjunction with the proposed Anti-Fraud Rule. Under the current accredited investor rule, a natural person is considered an "accredited investor" eligible to invest in private offerings, if that investor has a net worth of $1 million (inclusive of a residence) or $200,000 in income in the last two years or $300,000 in joint income with a spouse (if investing jointly) in the last two years.[15]

The Accredited Natural Person Rule would consist of a two part test. The rule would include the same net worth/income test as before. In addition, the rule would require that the investor hold $2.5 million in investments (exclusive of a residence). The $2.5 million investment requirement is modeled on a similar requirement for investor eligibility for investments in Section 3(c)(7) funds.[16] The test's second part would also contain an inflation adjustment. Every five years beginning in 2012, the $2.5 million threshold would be changed and rounded to the nearest $100,000 based on the inflation rate over those past five years.

During the question and answer period among the Commissioners and the staff, there was a discussion of the limits of the applicability of the new Accredited Natural Person Rule. Staff members noted that the current 3(c)(1) accredited investor definition applies to investments in private equity funds and venture capital funds, but the enhanced accredited investor definition would not apply to certain venture capital funds.[17] The staff explained that venture capital funds are vital in the funding of small start-up businesses. Accordingly, the Accredited Natural Person Rule would treat venture capital funds as essentially private business development companies.[18] Commissioner Atkins labeled this new, disparate treatment as a "political rationale."

Commissioner Campos noted that the new accredited investor rule would affect only a fraction of hedge funds, because most of them are 3(c)(7) funds. The Proposing Release also notes that the Accredited Natural Person Rule would not change the fact that a

13 Proposing Release, *supra* note 2.

14 The Proposing Release did include a few examples of frauds including, "false or misleading statements made, for example, to existing investors in account statements as well as to prospective investors in private placement memoranda, offering circulars, or responses to 'requests for proposals.'"

15 Rule 501(a) and Rule 215 of the Securities Act of 1933, as amended.

16 *See* Proposing Release, *supra* note 2.

17 For purposes of the proposed Hedge Fund Rules, the term " venture capital fund" would have the same meaning as the definition of business development company in Section 202(a)(22) of the Advisers Act. The term in that Section is modeled after the definition of business development company in Section 2(a)(48) of the Investment Company Act, with some modifications. *See* Proposing Release, *supra* note 2.

18 *Cf.*, Sections 54-65 of the Investment Company Act giving special treatment of public business development companies.

3(c)(1) hedge fund may seek-out 35 non-accredited investors for investment in the fund.[19] Moreover, Regulation D is an elective safe harbor, so private placements may be made without following its requirements.

Finally, of significant importance to current accredited investors is the applicability of the new standard to those already invested in hedge funds. The staff explained that eligibility as an accredited natural person would be measured at the time of investment. Therefore, those already invested in hedge funds would be grandfathered as to existing investments, but if those investors did not subsequently meet the requirements of the second prong of the test, they would not qualify as accredited investors when making any new investments in either the current fund or any other private fund.

The SEC staff's primary rationale behind its new accredited investor standard seems to be an effort to limit the number of investors who may qualify to invest in hedge funds to only those considered to be sophisticated investors. The value of a person's aggregate investment is presumed by the Accredited Natural Person Rule to be an appropriate surrogate for financial sophistication.

The staff demonstrated the expected effect of the new standard using historical economic data. When the current accredited investor rule was first promulgated in 1982, the staff estimates that only 1.82% of households had the requisite income level or net worth required for eligibility. Because of the effect of inflation and increase in the value of residential real estate since 1982, the number of qualifying households had risen to 8.5% as of 2004.

The staff noted that the current rules equate rote net worth and high income levels with investor savvy and sophistication. The enhanced standard would reduce the number of qualifying households by 88% to 1.29%. Commissioner Atkins objected to the staff's reasoning, pointing out that those investors who already qualified as accredited investors have enough net worth and income to seek the investment advice they need and to enlist and lobby for the regulatory protections they deserve. In that sense, he added, their personal level of investments is irrelevant.

19 Proposing Release, *supra* note 2.

Importantly, employees of a hedge fund manager who meet the current test but do not qualify as Accredited Natural Persons, but would no longer be able to invest in 3(c)(1) funds (ironically, would be able to invest in 3(c)(7) funds) even if they would otherwise be knowledgeable employees, unless the manager was willing to grant that employee one of the 35 slots available in a 3(c)(1) fund for non-accredited investors.

Although the two proposed hedge fund rules were unanimously approved for release, of all the topics discussed at the open meeting, the two proposed rules seemed to garner the most questions and concerns on the parts of the Commissioners. Several of the Commissioners stressed that commenters should write in on a variety of aspects of the proposed rules, but most especially about any possible unintended consequences of the proposed antifraud and accredited investor rules.

In the weeks following the open meeting, the enhanced accredited investor test came under strong criticism from small and start-up hedge funds that claimed they would bear the greatest burden under the new rule. They pointed out that a large percentage of new investment in hedge funds comes from institutional investors that would not be affected by the new rule. Thus, instead of having any meaningful impact on the *number* of investors who actually invest in hedge funds (as opposed to those who simply qualify to invest), the new rule would have a significant effect on start-up funds and promising managers creating their own funds.[20]

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This update was authored by George J. Mazin (+1 212 698 3570; george.mazin@dechert.com), David A. Vaughan (+1 202 261 3355; david.vaughan@dechert.com), Anthony Zacharski (+1 860 524 3937; anthony.zacharski@dechert.com), Alan Rosenblat (+1 202 261 3332; alan.rosenblat@dechert.com), and Audrey Wagner (+1 202 261 3365; audrey.wagner@dechert.com).

20 "Little Guy Protected, But Not Little Hedge Funds," *Hedge Fund Daily*, Dec. 15, 2006; "Revised Hedge Fund Limits May Have Limited Impact," *Hedge Fund Daily*, Dec. 13, 2006.

Dechert LLP

Practice group contacts

For more information, please contact the authors, one of the attorneys listed, or any Dechert attorney with whom you regularly work. Visit us at www.dechert.com/financialservices.

Margaret A. Bancroft
New York
+1 212 698 3590
margaret.bancroft@dechert.com

Allison R. Beakley
Boston
+1 617 728 7124
allison.beakley@dechert.com

Sander M. Bieber
Washington, D.C.
+1 202 261 3308
sander.bieber@dechert.com

Stephen H. Bier
New York
+1 212 698 3889
stephen.bier@dechert.com

Christopher Christian
Washington, D.C.
+1 202 261 3321
christopher.christian@dechert.com

Timothy M. Clark
New York
+1 212 698 3652
timothy.clark@dechert.com

Elliott R. Curzon
Washington, D.C.
+1 202 261 3341
elliott.curzon@dechert.com

Douglas P. Dick
Newport Beach
+1 949 442 6060
douglas.dick@dechert.com

Steven Drachman
New York
+1 212 698 5627
steven.drachman@dechert.com

Jennifer O. Epstein
Washington, D.C.
+1 202 261 3446
jennifer.epstein@dechert.com

Ruth S. Epstein
Washington, D.C.
+1 202 261 3322
ruth.epstein@dechert.com

Susan C. Ervin
Washington, D.C.
+1 202 261 3325
susan.ervin@dechert.com

Joseph R. Fleming
Boston
+1 617 728 7161
joseph.fleming@dechert.com

Brendan C. Fox
Washington, D.C.
+1 202 261 3381
brendan.fox@dechert.com

Wendy Robbins Fox
Washington, D.C.
+1 202 261 3390
wendy.fox@dechert.com

David M. Geffen
Boston
+1 617 728 7112
david.geffen@dechert.com

David J. Harris
Washington, D.C.
+1 202 261 3385
david.harris@dechert.com

Robert W. Helm
Washington, D.C.
+1 202 261 3356
robert.helm@dechert.com

Jane A. Kanter
Washington, D.C.
+1 202 261 3302
jane.kanter@dechert.com

Stuart J. Kaswell
Washington, D.C.
+1 202 261 3314
stuart.kaswell@dechert.com

George J. Mazin
New York
+1 212 698 3570
george.mazin@dechert.com

Jack W. Murphy
Washington, D.C.
+1 202 261 3303
jack.murphy@dechert.com

John V. O'Hanlon
Boston
+1 617 728 7111
john.ohanlon@dechert.com

Fran Pollack-Matz
Washington, D.C.
+1 202 261 3442
fran.pollack-matz@dechert.com

Jeffrey S. Puretz
Washington, D.C.
+1 202 261 3358
jeffrey.puretz@dechert.com

Jon S. Rand
New York
+1 212 698 3634
jon.rand@dechert.com

Robert A. Robertson
Newport Beach
+1 949 442 6037
robert.robertson@dechert.com

Keith T. Robinson
Washington, D.C.
+1 202 261 3386
keith.robinson@dechert.com

Alan Rosenblat
Washington, D.C.
+1 202 261 3332
alan.rosenblat@dechert.com

Frederick H. Sherley
Charlotte
+1 704 339 3100
frederick.sherley@dechert.com

Patrick W. D. Turley
Washington, D.C.
+1 202 261 3364
patrick.turley@dechert.com

Brian S. Vargo
Philadelphia
+1 215 994 2880
brian.vargo@dechert.com

David A. Vaughan
Washington, D.C.
+1 202 261 3355
david.vaughan@dechert.com

Anthony H. Zacharski
Hartford
+1 860 524 3937
anthony.zacharski@dechert.com

Dechert LLP

www.dechert.com

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