



## Regulatory Update — SEC Proposes New Rules Affecting Hedge Funds <sup>1</sup>

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The Securities and Futures Market Regulation Group

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The Securities and Exchange Commission (“SEC”) recently published a release (the “Release”) in which it proposes to adopt new rules “designed to provide additional investor protections” for persons who have invested, or wish to invest, in hedge funds.<sup>2</sup> This proposal is another attempt by the SEC to impose regulatory boundaries on the activities of hedge funds. In 2004, the SEC adopted rules that required many hedge fund managers to register as investment advisers under the Investment Advisers Act of 1940 (“Advisers Act”).<sup>3</sup> However, those rules were vacated last June by the court of appeals in *Goldstein v. SEC*.<sup>4</sup> The court held that the SEC’s rule requiring investors in a hedge fund to be counted as clients of the fund’s adviser — for purposes of the exemption in the Advisers Act for advisers that have fewer than 15 clients — was invalid because it conflicted with the purposes underlying the statute as well as the SEC’s prior interpretations of its own rules.

The SEC responded to its defeat in court, in part, by proposing the new rules described below. First, the SEC proposes to adopt a new antifraud rule to reinforce the SEC’s ability to bring enforcement actions under the Advisers Act against investment advisers (whether registered or not) who defraud investors or prospective investors in a hedge fund. Second, the SEC proposes new rules that would revise the definition of “accredited investor” to make it harder for natural persons to invest in hedge funds.

### Proposed Antifraud Rule

In *Goldstein*, the court held that a hedge fund adviser’s “client” under the Advisers Act was the fund itself, and not the individual investors in the fund. This is significant because Sections 206(1) and (2) of the Advisers Act prohibit investment advisers from engaging in fraudulent conduct affecting a “client or prospective client.” Prior to the *Goldstein* decision, the SEC had routinely brought enforcement actions against hedge fund advisers alleging fraud on individual investors pursuant to those sections. The *Goldstein* decision threw into doubt the SEC’s ability to continue to prosecute such actions. To eliminate that doubt, the SEC proposes to adopt a new antifraud rule pursuant to the authority granted to the SEC by Section 206(4), a catch-all provision that prohibits “any act, practice, or course of business which is fraudulent, deceptive, or manipulative.” Notably, the provision does not require that the “fraudulent, deceptive, or manipulative” practices affect any “client.”

Proposed Rule 206(4)-8 would prohibit any investment adviser to a “pooled investment vehicle” from making any untrue statement of a material fact or omitting to state a material fact necessary to make the statements made not misleading, or otherwise engaging 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. A “pooled investment vehicle” is defined as any investment company under the Investment Company Act of 1940 (“Investment Company Act”) or any company that would be an investment company but for the exclusions provided by Sections 3(c)(1) or 3(c)(7) of the Investment Company Act.<sup>5</sup> Thus, the scope of this proposed rule is quite broad — it would apply to the investment adviser (whether registered or not) of any fund that invests in securities, including hedge funds, private equity funds and venture capital funds.<sup>6</sup>

The language in the proposed rule is drawn from many of the antifraud provisions already existing in the securities laws, including Rule 10b-5 under the Securities Exchange Act of 1934 (“Exchange Act”). Unlike as is required under Rule 10b-5, however, the SEC believes that it would not be required to demonstrate scienter to establish a violation of the proposed rule. The SEC reasons that Section 206(4) of the Advisers Act has been held not to require a demonstration of scienter,<sup>7</sup> and therefore any rules promulgated pursuant to Section 206(4) likewise do not require a demonstration of scienter. Also unlike Rule 10b-5, the proposed rule is not limited to fraud “in connection with the purchase or sale of any security.” The SEC observes that the proposed rule would prohibit advisers to “pooled investment vehicles” from making any false or misleading statements to investors or prospective investors, “regardless of whether the pool is offering, selling, or redeeming securities.”<sup>8</sup> Thus, the proposed rule would cover a broad range of potential conduct. For example, the rule would appear to apply to negligent misrepresentations by an unregistered hedge fund adviser to any prospective investor. The proposed rule is not intended to create any private right of action.<sup>9</sup>

### Revised Definition of “Accredited Investor”

Most hedge funds avoid registering their offerings of securities by relying on the private offering exemptions provided by Section 4(2) of the Securities Act of 1933 (“Securities Act”) and Regulation D promulgated thereunder. In particular, Rule 506 of Regulation D allows hedge funds to offer unregistered securities to an unlimited

number of “accredited investors,” as well as up to 35 non-accredited investors with sufficient knowledge and experience in financial and business matters that they are capable of evaluating the merits and risks of the prospective investment. Rule 215 under the Securities Act and Rule 501(a) of Regulation D both define an “accredited investor” as including any natural person whose individual net worth, or joint net worth with the person’s spouse, exceeds \$1 million, or who had an individual income of more than \$200,000 in the two most recent years, or a joint income with the person’s spouse of more than \$300,000, and has a reasonable expectation of reaching that income level in the current year.

The SEC noted that the net worth and income tests for accredited investors, which have remained unchanged since 1982, have allowed an increasing number of persons who may lack financial sophistication to invest in hedge funds. The SEC expressed concern that unsophisticated investors may not appreciate the “unique risks” posed by hedge funds such as undisclosed conflicts of interest and complex fee structures.<sup>10</sup> To remedy this perceived problem, the SEC proposes to adopt new Rules 216 and 509, which would create a new category of accredited investors, called “accredited natural persons,” who must own \$2.5 million in specified “investments,”<sup>11</sup> as well as satisfy the existing net worth or income tests. This new category would apply only with respect to offers and sales of securities issued by a “private investment vehicle,” another new term created by the proposed rules.

The definition of a “private investment vehicle” is different than the definition of a “pooled investment vehicle” under the proposed antifraud rule. A “private investment vehicle” is defined as any issuer that would be an investment company but for the exclusion provided in Section 3(c)(1) of the Investment Company Act. A “private investment vehicle” would not include funds exempted from the definition of an investment company by Section 3(c)(7) of the Investment Company Act because natural person investors in those funds are already required to own not less than \$5 million in investments. The proposed rules also specifically exclude from the definition of a “private investment vehicle” any “venture capital fund,” which has the same definition as a “business development company” under the Advisers Act.<sup>12</sup>

For purposes of reaching the \$2.5 million valuation, the “investments” of the prospective “accredited natural person” must be valued according to their fair market value on the most recent practicable date or their cost. Any

outstanding indebtedness incurred to acquire the “investments” must be deducted from the valuation. Unless spouses are investing jointly, the prospective “accredited natural person” can only count 50 percent of any “investments” held jointly or as community property with the person’s spouse toward the \$2.5 million figure. An individual is allowed to include “investments” held in an individual retirement account. The proposed rules also provide for an inflation adjustment of the \$2.5 million figure, which would occur in 2012 and every five years thereafter.

### Questions Raised by the Proposed Rules

The revised definition of “accredited investor” does not contain a grandfather clause to allow current accredited investors who do not meet the proposed definition of an “accredited natural person” to make additional hedge fund investments, even in funds in which they have already invested<sup>13</sup> (although investors presumably could maintain the investments they already hold). Further, the inflation adjustment provisions to the “accredited natural person” definition have the potential to make individuals ineligible to invest in hedge funds even though they had been considered “accredited natural persons” in the previous year. The SEC is requesting comment on whether there should be a grandfather provision to allow existing investors to make additional investments in the same funds, as well as on the desirability of, and the proposed methodology for, adjusting the dollar level in the definition every five years.

The proposed definition of “accredited natural person” does not contain any exceptions for employees of the hedge fund or its manager. Hedge funds operating under the Section 3(c)(7) exemption in the Investment Company Act, which normally requires that natural person investors own at least \$5 million in investments, have permitted senior employees not meeting that standard to invest in the fund pursuant to the “Knowledgeable Employee” exception set forth in Rule 3c-5 under the Investment Company Act.<sup>14</sup> The SEC is requesting comment on whether a similar exemption should be added to the proposed rules.

Finally, as noted above, the proposed definition of a “private investment vehicle” specifically excludes any “venture capital fund,” which is defined as a business development company under the Advisers Act. To justify this exclusion, the SEC does not argue that venture capital funds are inherently less risky than hedge funds. Instead, the SEC apparently believes that venture capital funds are more deserving of investment capital than hedge funds,

stating in the Release that it “recognize[s] the benefit that venture capital funds play in the capital formation of small businesses.”<sup>15</sup> The SEC is requesting comment on whether it is appropriate to exclude venture capital funds from the proposed rules and, if so, how venture capital funds should be defined for purposes of such exclusion.

In addition to the specific questions noted above, the SEC seeks comment more generally on all aspects of the proposed rules. Comments should be received by the SEC on or before March 7, 2007.

## Endnotes

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<sup>1</sup> This paper is intended as a brief description of recent SEC action and not as legal advice.

<sup>2</sup> Release No. 33-8766 (Dec. 27, 2006), 72 FR 400 (Jan. 4, 2007).

<sup>3</sup> See Investment Advisers Act Release No. 2333 (Dec. 2, 2004), 69 FR 72054 (Dec. 10, 2004).

<sup>4</sup> *Goldstein v. SEC*, 451 F.3d 873 (D.C. Cir. 2006).

<sup>5</sup> Sections 3(c)(1) and 3(c)(7) are the provisions most often used by hedge fund organizers to avoid registration under the Investment Company Act. The provisions exclude from the definition of an investment company: (a) issuers the securities of which are beneficially owned by not more than 100 persons and that are not making or proposing to make any public offering; and (b) issuers the outstanding securities of which are owned exclusively by persons who are “qualified purchasers” under the Investment Company Act and that are not making or proposing to make any public offering.

<sup>6</sup> 72 FR at 402.

<sup>7</sup> See *SEC v. Steadman*, 967 F.2d 636 (D.C. Cir. 1992).

<sup>8</sup> 72 FR at 403.

<sup>9</sup> 72 FR at 403.

<sup>10</sup> 72 FR at 404.

<sup>11</sup> The definition of “investments” is similar to the definition found in Rule 2a51-1 under the Investment Company Act. “Investments” are defined as any securities other than those issued by an issuer that is controlled by the prospective investor, unless the issuer is: (a) an investment company or any company that would be an investment company but for the exclusions provided in Sections 3(c)(1)-(9) of the Investment Company Act; (b) a company whose securities are registered under the Exchange Act or listed on a “designated offshore securities market” as defined by Regulation S under the Securities Act; or (c) a company that, within 16 months of the date of the proposed investment, had shareholders’ equity of not less than \$50 million. “Investments” also include real estate held for investment purposes, but not real estate used as a personal residence or as a place of business, or in connection with a trade or business. “Investments” further include commodity interests, physical commodities or financial contracts, but only those held by persons who are engaged primarily in the business of investing, reinvesting or trading in those products. Finally, “investments” also include cash and cash equivalents.

<sup>12</sup> Section 202(a)(22) of the Advisers Act defines a “business development company” as any company which: (a) is organized under the laws of, and has its principal place of business in, any State or States; and (b) is operated for the purpose of making investments in securities described in paragraphs 1 through 3 of Section 55(a) of the Investment Company Act, and may make available significant managerial assistance with respect to the issuers of such securities. A business development company is prohibited from acquiring certain assets unless assets described in paragraphs 1 through 6 of Section 55(a) of the Investment Company Act represent at least 60 percent of the total value of the business development company’s assets.

<sup>13</sup> 72 FR at 406.

<sup>14</sup> Under Rule 3c-5, the term “Knowledgeable Employees” includes executive officers, directors, trustees, general partners and advisory board members of a private fund, as well as certain other employees who participate in investment activities and have performed such functions for at least 12 months.

<sup>15</sup> 72 FR at 408.

## For Further Information

If you have questions concerning this Update, or if you would like to discuss preparing a comment letter on the SEC's proposed rules, contact any of the following members of our Securities and Futures Market Regulation Group:

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