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Hedge Fund Investor Protection – Current SEC Rulemaking with Regard to Rule 206 and the Accredited Investor Standard¹

The U.S. securities laws contain numerous provisions designed to protect investors in securities. Recently the U.S. Securities and Exchange Commission (SEC) issued a new set of proposed rules to prohibit advisers to pooled investment vehicles from making false or misleading statements or otherwise defrauding investors or prospective investors in those vehicles and to make more stringent the suitability standards needed for investors to invest in hedge funds.² The article is addressed to those proposals, specifically (i) proposed Rule 206(4)-8 under Section 206 of the Investment Adviser's Act of 1940, as amended (Advisers Act) – the so called “anti-fraud” rule – and (ii) the changes proposed with regard to the accredited investor standard and related definitions. Whether or not ultimately made final, what is certain is that the proposed Rule demonstrates the commitment of the SEC to increase the level of protection of investors into hedge fund vehicles.

Proposal with Regard to Rule 206

Under the Proposed Rule 206(4)-8 it will constitute a fraudulent, deceptive or manipulative act, practice, or course of business within the meaning of Section 206(4) of the Advisers Act for any investment adviser to a pooled investment vehicle to (1) make any untrue statement of a material fact or to omit to state a material fact necessary to make the statements made, in light of the circumstances under which they were made, not misleading, to any investor or prospective investor in the pooled investment vehicle; (2) 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. In this context, the term pooled investment vehicle, a new term, means an investment company that would be required to register as such under the

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² See SEC Release No. 33-8766 issued December 27, 2006 entitled “Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles; Accredited Investors in Certain Private Investment Vehicles.” (Release)

Investment Company Act of 1940, as amended (Company Act) but for the exceptions set forth in either sections 3c1 or 3c7 of the Company Act.³

In practical terms, the effect of the new rule is to prohibit, for example, materially false or misleading statements in areas that very often contain some “puff” or wishful overstatements or which in the past may have lacked the precision and clarity desired by the SEC. For example, statements regarding investment strategies that the fund will pursue, the biographical data with regard to the decision makers (credentials, experience, and the like), the risks associated with the strategy or an investment in the deal, performance of course, valuation methodology and practice, allocation of opportunities among competing interests, and the general practices that the adviser may or may not use in connection with its business operations.

In short, the SEC’s message is that investment advisers cannot commit fraud. Sounds simple enough and it should be but as is the usual case when dealing with matters involving hedge funds, nothing is as clear as it might seem. So let’s dissect the Release to better understand its impact. And note that under the new rules, no “scienter” (intent) need to be shown before the SEC can sanction an adviser – no intent to defraud is needed.⁴ Honest mistakes or oversights will trigger the Rule if adopted.

Let’s look at who is within the scope of the proposals.

The Investment Adviser

Under US law, an investment adviser is defined as any person who, for compensation, engages in the business of advising others, either directly or through publications or writings as to the value of securities or as to the advisability of investing in, purchasing or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities.⁵ The label (in the US at least) is unimportant – a person meeting this definition, by whatever name called, is an investment adviser within the Advisers Act.

While in certain cases the Advisers Act (and even parts of Rule 206 itself) applies only to SEC *registered* investment advisers, not so with the current Rule 206(4). It applies to *all* investment advisers, whether or not registered as such under the Advisers Act. It is significant therefore that the SEC proposed Rule 206(4)-8 as part of Rule

³ Under the Company Act, section 3c1 excludes from the definition of investment company (and therefore eliminates the registration requirement) an issuer of securities that are beneficially owned by not more than 100 persons and that is not making or proposing to make a public offering. Section 3c7 excludes from the definition of investment company an issuer the outstanding securities of which are owned exclusively by persons who, at the time of acquisition of such securities, are “Qualified Purchasers,” and that is not making or proposing to make a public offering. “Qualified Purchaser” generally refers to a natural person who owns not less than US\$5 million in investments or to an entity that invests on a discretionary basis, not less than US\$25 million. The term investments is also defined; see materials on the author’s website www.thshlaw.com.

⁴ *SEC v. Steadman* 967 F 2d 636 (DC Cir 1992).

⁵ Advisers Act, sec. 202(A)(11).

206(4); accordingly, if adopted it would apply to *all* investment advisers – registered or not.

Who is to be Protected?

The significance of the Release, the “story behind the story” if you will, emanates from the opinion of the Court of Appeals for the District of Columbia circuit, Goldstein v. SEC (Goldstein).⁶ Goldstein called into question the definition of “client” not only in the context of the registration requirements for investment advisers (last year’s story) but also expressed the view that for purposes of Secs. 206(1) and 206(2), also anti-fraud sections, the term “client” means the investment pool, not the investors in the pool.⁷ Section 206(4) was never so limited – only Secs. 206(1) and 206(2) were. Section 206(4) is broader in scope and is not aimed at clients or prospective clients. It permits the SEC to adopt rules addressed to fraudulent conduct, whether or not directed to a “client.” No doubt, this is a further reason that the SEC has issued the proposals under Sec. 206 in proposing Rule 206(4)-8.

As a result, the potential victim can be the investment fund (i.e. the pooled investment vehicle), an investor in the fund and in fact even a *potential* investor in the fund. A very broad universe, indeed.

Other Matters

There is no private right of action created under the Release. This means that investors who may feel that they are aggrieved may not sue the adviser under Rule 206(4)-8.⁸ That’s reserved to the SEC. And no fiduciary relationship is intended to be created between the adviser and client if one does not already exist.

Proposal with Regard to Accredited Investor Status

First some background: Under the US Securities Act of 1933, as amended (33 Act), a private placement exemption was adopted years ago, Regulation D. Offerings of securities conducted in accordance with the “safe harbor” criteria set forth in Regulation D are nonpublic offerings such that no full blown SEC registration is required. Privately offered investment pools generally rely on Rule 506 of Regulation D in the offering of their securities. Rule 506 permits offers and sales of securities to an unlimited number of “accredited investors” and limited number (35) of non-accredited investors without registering such securities under the 33 Act.

⁶ 451 F. 3d. 873 (DC Cir 2006).

⁷ Generally, advisers can avoid registration if they have less than 15 clients.

⁸ Transamerica Mortgage Advisors, Inc. v. Lewis, 444 US 11 (1979).

Rule 501(a) of Regulation D defines several categories of accredited investor.⁹ There is a “net worth” test and an “income” test – the investor needs to meet one or the other under current law. A natural person is an accredited investor if that person’s individual net worth, or joint net worth with that person’s spouse, at the time of the purchase of the security, is at least \$1,000,000, or that person has individual income that exceeds \$200,000 in each of the two most recent years or joint income with that person’s spouse in each of those years exceeds \$300,000, and there is a reasonable expectation of reaching the same income level in the current year.¹⁰ The SEC notes in the Release that it adopted these net worth and income standards back in 1982 based on its view that these tests would provide appropriate and objective standards to meet its goal of allowing investments in private offerings only by such persons who are capable of evaluating the merits and risks and of that investment.¹¹ Inflation, along with the sustained growth in wealth and income of the 1990’s, has boosted a substantial number of investors past the “accredited investor” standard but neither test was indexed in any way.

Now to the Release: According to the SEC, it now seeks to protect investors that may be investing in certain funds, to be called “private investment vehicles.” A “private investment vehicle” is a 3c1 fund for purposes of the proposed rules but is more narrowly defined than a “pooled investment vehicle” as that term is used in connection with proposed Rule 206(4)-8.¹² (Why one Release contains two separate but very close definitions is bound to cause confusion; perhaps the final rules will take a different tack.) Lastly, the offer and sale of securities by venture capital funds would be specifically excluded from the application of the proposed rules.

Proposed Rules 509 and 216

Under the proposed rules, “accredited investor” is redefined with reference to natural persons investing in a private investment vehicle (i.e., a 3c1 fund). It will only cover those investments. And for this reason, a new label is applied: accredited natural person (to differentiate that investor from one who is merely an accredited investor.) An

⁹ Such investors include banks, savings and loan associations, registered broker dealers, registered investment companies, certain state-sponsored employee benefit plans, non-profit organizations organized under section 501(c)(3) of the Internal Revenue Code with total assets exceeding \$5,000,000, certain natural persons, trusts with assets exceeding \$5,000,000 and entities in which all of the equity owners are accredited investors.

¹⁰ Regulation D, Rule 501(a)(5) and (6). Note that the SEC staff is also requesting comment on whether these thresholds should be increased.

¹¹ Securities Act Release No. 6389 (Mar. 8, 1982). See, also, Securities Act Release No. 6758 (Mar. 3, 1988) (adopting \$300,000 joint income standard).

¹² As stated, a “private investment vehicle” is a more narrowly defined term than “pooled investment vehicle” that is described in connection with proposed Rule 206(4)-8. The latter term is broadly defined under proposed antifraud Rule 206(4)-8 to cover several types of privately offered pools, including 3c1 funds and 3c7 funds. “Private investment vehicle” is narrowly defined under Rules 509 and 216 to encompass 3c1 funds only. The proposed Rules do not apply to 3c7 funds which makes sense. The SEC states in the Release that the investor protections that it believes are lacking with respect to 3c1 funds already exist for 3c7 funds because natural persons who invest in such pools are required to own \$5 million in investments at the time of their investment and must also meet the definition of accredited investor. See note 3, above.

accredited natural person means a natural person who meets the \$200,000 and \$300,000 income thresholds and/or the \$1,000,000 net worth threshold of the original accredited investor definition but who also owns (individually, or jointly with that person's spouse (as further discussed below)) not less than \$2.5 million in "*investments*".¹³ This condition (the investment test) is added to determine financial sophistication and ability to bear economic risk.

The new prong (the investible asset test) is pretty steep. "Investments" would include securities; real estate held for investment purposes; commodity interests held for investment purposes; physical commodities held for investment purposes; to the extent not securities financial contracts entered into for investment purposes and cash or cash equivalents.¹⁴ Most notably, real estate would not be considered to be held for investment purposes by a prospective accredited natural person if it is used for personal purposes by such person (or a related person) or as a place of business, or in connection with the conduct of trade or business of the prospective accredited natural person.¹⁵ Thus, natural persons would not be able to count the value of their home toward the \$2.5 million threshold. Particularly for start-up funds, this represents a very significant change because it will reduce the population of eligible investors for such funds. Furthermore, for purposes of valuing "investments", the proposed rules would deduct the amount of any outstanding indebtedness incurred to acquire the investment owned by such person. The proposed rules also provide that the investments of a natural person seeking to make an investment in a private investment vehicle on his or her own behalf may include only 50% of: (a) any of such person's investments held jointly with that person's spouse; and (b) any investments in which the natural person shares a community property or similar shared ownership interest with that person's spouse.

The proposed test for natural persons is significant given that it would be considerably difficult for many natural persons to have sufficient "investments" to meet the \$2.5 million threshold.

Grandfathering

The Release includes only a partial grandfather provision. Currently invested natural persons who might no longer meet the definition of accredited investor are allowed to maintain their existing investments but they would not be able to make future investments in private investment vehicles, even those in which they are currently

¹³ The \$2.5 million threshold is subject to adjustment for inflation on April 1, 2012, and every five years thereafter.

¹⁴ Securities of issuers controlled by the investor are excluded for purposes of meeting the \$2.5 million threshold unless the issuer is a) an investment company (or would be an investment company but for the exclusions from that definition provided by 3c1 through 3c9 of the Company Act); b) a reporting company under section 13 or 15(d) of the 34 Exchange Act or has a class of securities listed on a "designated offshore securities market" as defined under Regulation S under the 33 Act; or (c) a company with shareholders' equity of not less than \$50 million.

¹⁵ A related person would mean a natural person who is a sibling, spouse or former spouse, or is a direct lineal descendant or ancestor by birth or adoption, of the prospective accredited natural person, or a spouse of such descendant or ancestor.

invested. And what about deals where otherwise grandfathered investors have committed to future calls on capital after the effective date of the new rule? To be determined, one hopes, in the final release.

Conclusion

The Release is broad and focuses on the nature of the investor on one hand and on the prohibitions against fraud by the investment adviser on the other. This double barrel attack serves notice on the industry that the SEC is quite serious about protecting investors in hedge funds – a goal with which it is hard to argue. The Rules are “proposed” meaning that the SEC is soliciting comments from industry participants as to the impact, suggested additions, deletions, and the like. It remains to be seen what changes, if any, will be made before the Release is issued in final form.

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