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Private Investment Funds Practice Update

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SEC Proposes Increase in Accredited Investor Test, Anti-Fraud Rule for Private Funds

On December 27, 2006, the SEC issued a Release proposing new rules designed to provide additional protections to investors in private investment funds, including hedge funds and private equity funds. The first proposal would create a new antifraud rule pursuant to the Investment Advisers Act of 1940 that would prohibit advisers from making false or misleading statements or otherwise defrauding investors in any pooled investment vehicle, as defined in the rule. The second proposal would define a new category of accredited investor, called "accredited natural person," that would apply to offers and sales of securities to natural persons investing in pooled investment vehicles relying on the exemption under Section 3(c)(1) of the Investment Company Act of 1940.

New Anti-Fraud Rule

Proposed Rule 206(4)-8 under the Investment Advisers Act is intended to address possible uncertainty created by the court decision in *Goldstein v. Securities and Exchange Commission.* The new rule would prohibit advisers from making false or misleading statements or otherwise defrauding investors in any pooled investment vehicle.

The proposed rule would encompass all investment advisers, whether or not registered with the SEC, and also would cover most hedge funds and private equity funds, by defining "pooled investment vehicle" as any investment pool that would be an investment company but for the exemptions provided in Sections 3(c)(1) and 3(c)(7) of the Investment Company Act.

Unlike other anti-fraud provisions in the U.S. securities laws, the proposed rule would apply to all materially false or misleading statements made to investors or prospective investors, regardless of whether the pool is offering, selling or redeeming securities. A finding of scienter will not be required to prove a violation of the proposed rule. No private cause of action will be created by the rule.

New Accredited Investor Standard

Proposed Rules 509 and 216 under the Securities Act of 1933 would define a new category of accredited investor, called "accredited natural person," that would apply to offers and sales of securities issued by private investment vehicles relying on the exemption under Section 3(c)(1) of the Investment Company Act. The new definition would require a natural person to meet the current $1,000,000 net worth or $200,000 ($300,000 with spouse) annual income test, and also to own at least $2,500,000 in "investments" as defined in the proposed rules. Under the proposed rules, the $2,500,000 amount will be adjusted for inflation on April 1, 2012 and every five years thereafter.

The proposed $2,500,000 test will not apply to potential investors in Section 3(c)(7) funds, which are already subject to the higher "qualified purchaser" standard, or to potential investors in "venture capital funds," which the proposed rules define in the same manner as the "business development company" definition in Section 202(a)(22) of the Investment Advisers Act. For this purpose, a venture capital fund would have to satisfy certain tests as to the nature of its underlying investments, and as to the managerial assistance that it makes available to portfolio companies.

The proposed definition of "investments" is based on Rule 2a51-1 under the Investment Company Act (the test for qualified purchasers under Section 3(c)(7)), but includes certain differences. In particular, under the proposed rule, when an investor invests independently of his or her spouse, the investing spouse may count only 50% of the value of jointly held or community property interests toward the $2,500,000 requirement. Similarly to Rule 2a51-1, investments would not include real estate used by the investor or certain of his or her family members for personal purposes or in connection with a trade or business.

Under the proposed rules, a Section 3(c)(1) fund could still accept up to 35 non-accredited investors who do not meet the new "accredited natural person" definition. However, as under the existing rules, additional disclosure requirements would apply to any non-accredited investors.

The SEC is seeking comments on the proposed rules until March 9, 2007.

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Private Investment Funds Practice Update

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