Legal Updates & News

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SEC Proposes New Anti-Fraud Rule and Changes to the Definition of "Accredited Investor" for Private Investment Vehicles

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The Securities and Exchange Commission (the "SEC") recently released for public comment proposed new rules aimed at providing additional investor protections for investors in pooled investment vehicles. The proposed new rules would (i) prohibit advisers to pooled investment vehicles from making false and misleading statements or otherwise defrauding investors or prospective investors in such vehicles, and (ii) revise the definition of "accredited investor" as it relates to individual investors.[1]

Proposed Anti-Fraud Rule

The SEC proposed new Rule 206(4)-8 under the Investment Advisers Act of 1940 (the "Advisers Act") following the recent *Goldstein v. SEC* court decision,[2] which overturned the SEC's rule that required most hedge fund managers to register as investment advisers with the SEC. The SEC proposed the rule to clarify, in light of the *Goldstein* decision, its ability to bring enforcement actions under the Advisers Act against unregistered investment advisers who defraud current or prospective investors in a hedge fund or other pooled investment vehicle.

Although the current anti-fraud statute in Section 206 of the Advisers Act applies broadly to investment advisers, other anti-fraud rules promulgated under Section 206 only apply specifically to registered advisers or to advisers required to be registered under the Advisers Act. The proposed new rule would broaden the scope of the SEC's anti-fraud provisions by applying them to any investment adviser to a pooled investment vehicle. The SEC makes clear that it intends to apply its anti-fraud rules to advisers not registered or required to be registered under the Advisers Act. [3] Thus, the proposed rule, as drafted, could also apply to advisers who are currently exempt from registration under the Advisers Act, as well as to non-U.S. advisers whose activities the SEC views within its jurisdiction.

The proposed rule would not distinguish between types of pooled investment vehicles. Rather, the proposed rule would serve to protect investors in both registered investment companies and private investment pools that are excluded from the definition of investment company under Section 3(a) of the Investment Company Act of 1940 (the "Company Act") pursuant to either Sections 3(c)(1) or 3(c)(7)[4] thereof. Thus, the new rule would apply to investment companies that are offered to the public (i.e., mutual funds), as well as to hedge funds, private equity funds, venture capital funds, and other types of privately offered pools that invest in securities.

Under the proposed rule, it would constitute a fraudulent, deceptive or manipulative act, practice, or course of business within the meaning of Section 206(4) for any investment adviser to a pooled investment vehicle to make any materially false and misleading statements to investors or prospective investors in a pooled investment vehicle. The rule would cover statements made by an adviser, for example, in a private placement memorandum or other offering documents, account statements, or responses to "requests for proposals." However, unlike other anti-fraud rules, such as Rule 10b-5 under the Exchange Act of 1934, the proposed new rule would not be limited to fraud in connection with the purchase or sale of securities. Accordingly, the proposed new rule would apply to advisers regardless of whether a pooled investment vehicle was offering, selling, or

redeeming securities. In effect, the proposed rule would apply to a broader range of communications to investors or potential investors throughout a pooled investment vehicle's term. Examples given by the SEC in the Release include statements about:

- the investment strategies that a pooled investment vehicle will pursue or may pursue in the future;
- the experience and credentials of the adviser or its associated persons;
- the risks associated with an investment in a pool;
- the performance of the pool or other funds advised by the adviser;
- the valuations of the pool or investor accounts in it; and
- the practices the adviser follows in operating its business.

The SEC also proposes to extend its new anti-fraud rule to apply broadly to deceptive conduct that may not involve statements. The SEC would not be required to prove that an adviser violating the new rule acted with scienter (i.e., acted with a mental state with intent to deceive, manipulate, or defraud). The proposed rule would not give rise to a private right of action against an adviser, nor would it create a new fiduciary duty to investors or prospective investors in a pooled investment vehicle. However, advisers remain subject to existing duties and obligations under the Advisers Act, and any other federal or state laws or regulations.

The SEC has requested comments to various aspects of the proposed new anti-fraud rule, including whether certain advisers to pools should be exempt (and why an exemption would be appropriate), and whether the new rule should apply to other companies excluded from the definition of investment company.

Proposed Revision to the "Accredited Investor" Definition

Many pooled investment vehicles rely on Rule 506 of Regulation D under the U.S. Securities Act of 1933 (the "Securities Act") in making offers and sales of their securities. Rule 506 provides, in part, that an issuer may sell its securities to "accredited investors" without registering the securities with the SEC. Under the current rules, an investor who is a natural person (e.g., an executive, employee, or angel investor) will qualify as an "accredited investor" if (i) his or her net worth (or joint net worth with his or her spouse) exceeds $1 million at the time of purchase, or if his or her income exceeds $200,000 (or joint income with his or her spouse exceeds $300,000) in each of the two most recent years, and (ii) the individual has a reasonable expectation of reaching the same income level in the year of investment (the "Accredited Investor Test").[5]

The SEC believes that a recent surge in investor wealth, attributable, in part, to the increased value of personal residences, has resulted in an increase in the number of individuals who satisfy the current Accredited Investor Test. As a result, the SEC is concerned that the existing test, which previously provided investor protection by requiring a level of financial sophistication and investment experience, may not afford sufficient protection to the increased number of investors, especially in light of the increasing complexity and risks associated with certain investment funds.

To address this concern, the SEC has proposed a new two-part test for individuals investing in "private investment vehicles." The new test would provide that an individual investing in a "private investment vehicle" (discussed below) will also need to qualify as an "accredited natural person." The "accredited investor" test for entities would remain the same.

Definition of "Accredited Natural Person"

To be an "accredited natural person" under the proposed rule, the individual would need to satisfy the following test (the "Accredited Natural Person Test"):

- satisfy the requirements of the current Accredited Investor Test, and
- own (individually, or jointly with his or her spouse) not less than $2.5 million in "investments" at the time of purchase.

The proposed definition of "investments" is based on the definition used in Rule 2a51-1 under the Company Act. Like Rule 2a51-1, "investments" would include securities, cash, or commodities held for investment purposes (including IRAs and other retirement accounts), and would exclude real estate used as a personal residence or business. Investments will be valued at their fair market value on the most recent practicable date or their cost. Unlike Rule 2a51-1, however, if only one spouse invests in a private investment vehicle, then under the proposed rule the spouse may only

count 50% of any investments held jointly towards the $2.5 million "investments" test. If the spouses invest together in the private investment vehicle, then 100% of the assets jointly owned would be counted towards the $2.5 million "investments" test. The SEC has proposed adjusting the $2.5 million threshold for inflation in 2012, and then every five years thereafter.

While the Accredited Natural Person Test is not intended to be retroactive, investors would not be permitted to make future investments in private funds, including funds in which they are currently invested, unless they satisfy the new requirements. It is unclear whether the SEC plans to make a distinction between hedge funds and private equity funds for purposes of this rule, other than venture capital funds, which would be exempt as described below. The SEC is soliciting comments on each part of the Accredited Natural Person Test, including the $2.5 million threshold, the definition of "investments," and the grandfathering provision.

Definition of "Private Investment Vehicles"

The Accredited Natural Person Test only applies to offers and sales of securities by "private investment vehicles." Under the proposed rules, "private investment vehicles" are defined as funds that rely on the 3(c)(1) Exception under the Company Act, but would exclude venture capital funds. The SEC did not believe it necessary to enhance protection for investors in funds that rely on the 3 (c)(7) Exception as such investors are already subject to a similar two-step test that requires them to own $5 million in investments.

Proposed Exclusion for Venture Capital Funds

The proposed rules would not apply to venture capital funds, which would have the same definition as "business development company" set forth in Section 202(a)(22) of the Advisers Act. This section would generally limit the definition to funds that are:

- organized and have their principal place of business in the U.S. (making this exclusion unavailable for non-U.S. funds),
- prohibited from making investments unless 60% of their assets are invested in certain types of securities, which generally include securities in small businesses organized under U.S. laws (making this exclusion unavailable for funds that invest significantly in offshore markets or leveraged buyout funds, real estate funds, fund of funds and others), and
- provide managerial assistance to companies that are counted against the 60% requirement described above.

The SEC is soliciting comments on this definition, and has suggested the possibility of using an alternative reference to the term "business development company" defined in Section 2(a)(48) of the Company Act[6] or a new definition of "venture capital funds" altogether.

Application to Employees of Private Investment Vehicles or Investment Advisers

The SEC is soliciting comments on whether employees of private investment vehicles or their investment advisers should be required to satisfy the proposed new Accredited Natural Person Test. While the SEC has not made a proposal on this point, if the rules do not exempt such employees or advisers, Section 3(c)(1) funds would be required to rely on alternative Securities Act exemptions, such as Rule 506 (allowing up to 35 non-accredited purchasers, provided that employees meet certain eligibility and information requirements), or Rule 701 (providing an exception for certain compensatory benefit plans and contracts relating to compensation), in addition to satisfying the 100-person limit for private investment vehicles relying on the 3(c)(1) Exception.

The SEC has also requested comment as to whether the SEC should add a separate requirement for "knowledgeable employees" (similar to Rule 3c-5 under the Company Act), which would allow certain private investment fund managers and employees to meet the Accredited Natural Person Test by virtue of their participation in the investment activities of the fund.

The SEC is requesting comments on the proposed rules by no later than March 9, 2007. The text of the proposed rules is available at http://www.sec.gov/rules/proposed/2006/33-8766.pdf.

Footnotes:

1: Prohibitions of Fraud by Advisers to Certain Pooled Investment Vehicles; Accredited Investors in Certain Private Investment Vehicles, Release No. 33-8766; IA-2576 (December 27, 2006) (the "Release").

2: *Goldstein v. Securities Exchange Commission*, 451 F.3d 873 (D.C. Cir. 2006) ("*Goldstein*").

3: The SEC would enforce the new rule through administrative and civil actions against advisers under Section 206(4) of the Advisers Act.

4: Section 3(c)(1) of the Company Act excepts from the definition of an investment company any issuer whose outstanding securities are beneficially owned by not more than 100 persons and that is not making a public offering of its securities (the "3(c)(1) Exception"). Similarly, Section 3(c)(7) of the Company Act excepts from the definition of investment company any issuer that does not make a public offering and whose securities are owned exclusively by persons who, at the time they acquired the securities, were "qualified purchasers" (the "3(c)(7) Exception").

5: See Rule 501(a) of Regulation D.

6: In contrast to the definition in Section 202(a)(22) of the Advisers Act, a business development company under the Company Act: (i) is prohibited from making investments unless 70% of its assets are invested in certain investments, and (ii) is generally required to purchase securities directly from its issuers or close affiliates.