

**SEC PROPOSES NEW ANTI-FRAUD RULE UNDER THE INVESTMENT
ADVISERS ACT OF 1940 AND AMENDMENTS TO THE PRIVATE FUND
“ACCREDITED INVESTOR” STANDARDS**

On December 13, 2006, the Securities and Exchange Commission (the “SEC”) unanimously voted to: (1) propose a new rule under the Investment Advisers Act of 1940 (the “Advisers Act”) to specifically prohibit fraud by investment advisers to pooled investment vehicles, and (2) propose amendments to the private offering rules under the Securities Act of 1933 (the “Securities Act”) to revise the criteria for a natural person to be considered an “accredited investor” for the purpose of investing in certain private funds. The SEC believes these proposals are a necessary response to a United States Court of Appeals decision earlier this year invalidating the hedge fund adviser registration rule in *Goldstein v. U.S. Securities and Exchange Commission*.¹

New Anti-fraud Rule Under Section 206(4) of the Advisers Act

Section 206(4) of the Advisers Act generally prohibits an investment adviser from engaging in any act, practice, or course of business to defraud a client or prospective client. The hedge fund adviser registration rule, adopted on October 26, 2004, required an investment adviser to a private fund to consider the underlying investors of the private fund as clients.² The *Goldstein* decision, however, overturned that rule and cast doubt on the duties of an adviser to underlying investors under the Advisers Act. The new anti-fraud rule would explicitly prohibit certain activities with respect to the underlying investors in private funds.

The proposed rule would make it a fraudulent, deceptive, or manipulative act, practice, or course of business for a registered or unregistered investment adviser to a pooled investment vehicle to make false or misleading statements or to otherwise defraud investors or prospective investors in that advised pool.³ 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 exemptions in Sections 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940 (the “1940 Act”). The SEC staff noted that this new anti-fraud rule would not provide underlying investors with a private right of action against investment advisers that engage in fraudulent behavior. This limitation on private rights of action would not impact any rights that investors may have under applicable state law.

¹ See Willkie Farr & Gallagher LLP Client Memorandum, “U.S. Court of Appeals Overturns Hedge Fund Adviser Registration Rule” (June 23, 2006), available at <http://www.willkie.com/firm/pubs.aspx>.

² See Registration Under the Advisers Act of Certain Hedge Fund Advisers, Investment Advisers Act Release No. 2333 (Dec. 2, 2004), available at <http://sec.gov/rules/final/ia-2333.htm>.

³ See “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” available at <http://www.sec.gov/news/press/2006/2006-208.htm>.

Amendments to Accredited Investor Criteria Under the Securities Act

The SEC, under Chairman Cox, has continually stated that it would aggressively push to keep unsophisticated investors out of hedge funds. The proposed amendment would create higher wealth standards and effectively prohibit certain investors from investing in hedge funds.

Rule 501(a)(1) currently allows an individual with a net worth of more than \$1 million or with an income of more than \$200,000 (or joint income of \$300,000 for married couples) per year for the past two years to be deemed an “accredited investor.”

The new “accredited investor” standard will require individuals investing in certain exempted investment pools (relying on an exemption in Section 3(c)(1) of the 1940 Act) to be both an “accredited investor” under the existing standards *and* own at least \$2.5 million in investments on the date of investment.⁴ Chairman Cox noted that the “accredited investor” standard has not been adjusted since 1982. The SEC staff indicated that the new “accredited investor” standard would not apply to individual investors in venture capital funds.

The new “accredited investor” standard directed at private funds addresses the SEC’s concerns for unsophisticated investors investing in certain private funds. In effect, personal residences and certain other personal assets would no longer be treated as contributing to an investor’s qualifying assets for private fund “accredited investor” standards. One possible impact of this rule may be to make it more difficult for the less senior employees of a private fund manager to invest in that manager’s private funds.

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⁴ See note 3 above.

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