SEC Proposes New Rules Potentially Affecting Hedge Funds

On January 4, 2007, the SEC proposed new rules affecting hedge funds. The rules were approved at an SEC meeting in December 2006.

Accredited Natural Persons

The SEC proposed to adopt a rule which would provide that a natural person investing in a "private investment vehicle" must both (i) qualify as an "accredited investor" under the requirements currently in effect (net worth exceeding $1 million either individually or together with such person's spouse, or individual income in excess of $200,000 or joint income with such person's spouse in excess of $300,000 in each of the two most recent fiscal years and a reasonable expectation of reaching the same income level in the current year); and (ii) satisfy an additional requirement of owning (either individually or together with such person's spouse) not less than $2.5 million in "investments." The rule refers to persons who meet both of these requirements as "accredited natural persons." The $2.5 million threshold would be adjusted every five years to account for inflation.

The proposed rule defines "private investment vehicle" as any issuer that would be an investment company but for the exclusion provided by Section 3(c)(1) of the Investment Company Act of 1940. Therefore, funds that meet the requirements of Section 3(c)(7) of the Investment Company Act of 1940 are not subject to this rule. Venture capital funds are also expressly excluded from the definition of "private investment vehicle."

The proposed rule defines "investments" in a similar manner as that used to determine if an investor is a "qualified purchaser."

In the release containing the text of the proposed rule, the SEC solicited comments on whether changes should be made to the proposed rule to allow employees of pooled investment vehicles or their investment advisers who do not qualify as accredited natural persons to invest in these funds, among other matters.

Application of Anti-Fraud Provision to Fund Investors

The SEC also proposed to adopt a rule which would provide that an investment adviser violates the Investment Advisers Act of 1940 if it makes any material misstatements or omissions to any investor or prospective investor in a pooled investment vehicle, or otherwise engages in any act, practice or course of business that is fraudulent, deceptive or manipulative with respect to any investor or prospective investor in a pooled investment vehicle.

The SEC proposed this rule in response to the recent *Goldstein v. SEC* decision, in which the Court of Appeals for the D.C. Circuit expressed the view that, for purposes of certain anti-fraud provisions of the Investment Advisers Act of 1940, the "client" of an investment adviser managing an investment pool is the investment pool, not the investors in the pool.

For purposes of this rule, "pooled investment vehicles" would include registered investment companies, as well as any company that would be an investment company but for Section 3(c)(1) or Section 3(c)(7) of the Investment Company

Act of 1940. This rule would apply both to registered investment advisers and to unregistered advisers, and would prohibit false and misleading statements both to existing investors (such as in account statements) and to prospective investors (such as in private placement memoranda).

Comments on the proposed rules should be provided on or before March 9, 2007.

Contact Information

If you have any questions or would like to learn more about any of these developments, please contact your usual legal advisor at Ropes & Gray LLP.