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March 9, 2007

Attn: Nancy M. Morris
Secretary
United States Securities and Exchange Commission
100 F. Street N.E.
Washington D.C. 20549-1090

Re: Release No. 33-8766, File No. S7-25-06, "Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles; Accredited Investors in Certain Private Investment Vehicles."

We appreciate the staff ("Staff") of the Securities and Exchange Commission ("Commission") providing us with the opportunity to comment on Proposed Rule 206(4)-8 under the Investment Advisers Act of 1940 (the "Advisers Act") and Rules 509 and 216 under the Securities Act of 1933 (the "Securities Act") (Proposed Rules 206(4)-8, 509 and 216 each individually, a "Proposed Rule" and collectively, the "Proposed Rules").

We commend the Commission for the proposals set forth in Release No. 33-8766 and IA-2576 (the "Proposing Release"). We support the Commission's objectives of increasing the accredited investor standards for investors in private investment vehicles, including hedge funds, and share the Commission's commitment to protecting investors in pooled investment vehicles from fraud.

Our comments relate to what we believe are the Commission's principal public policy objectives relating to hedge fund advisers, and to a lesser extent, advisers to other private investment pools. We believe these objectives are: (i) to incentivize investment advisers to register under the Advisers Act; and (ii) to promote transparency in the private fund industry.

We note that, in the Proposing Release, the Commission expressed its concern over the lack of transparency in the private fund industry and cited the lack of publicly available information about private investment pools to support its decision to raise the investor accreditation standards.[1] We have encouraged, and continue to encourage, the Commission and

[1] Securities Act Release No. 33-8766 (December 27, 2006) at 17.

the Staff to promote transparency by following the Staff's recommendations in its report "The Implications of the Growth of Hedge Funds"[2] at least with respect to elimination of the Rule 502(c) prohibitions on general solicitation or general advertising in private placement offerings of Section 3(c) (7) funds that are sold only to qualified purchasers."[3] In our view, eliminating such restrictions would significantly enhance transparency by allowing fund managers to maintain websites accessible to the public and to disseminate valuable information to the press concerning their funds. We encourage the Commission to consider exempting Section 3(c) (7) funds and Section 3(c)(1) funds from the Rule 502(c) general solicitation and advertising prohibitions if an adviser is registered with the Commission (which would be consistent with Section 203(b) under the Advisers Act). Adopting such an exemption would provide advisers with an incentive to register with the Commission without interfering with the Commission's mandate regarding investor protection. The Commission has publicly stated on numerous occasions that it believes requiring registration of investment advisers promotes investor protection and helps deter fraud.[4]

Accordingly, we urge the Commission to consider how the proposals set forth in the Proposing Release correlate to the foregoing objectives.

I. Proposed Rule 206(4)-8

Proposed Rule 206(4)-8 under the Advisers Act would make it a "fraudulent, deceptive, or manipulative act, practice, or course of business" within the meaning of Section 206(4) of the Advisers Act for a registered or unregistered adviser to make false or misleading statements of material facts or to otherwise defraud existing or prospective investors in pooled investment vehicles. We are concerned that Proposed Rule 206(4) (especially Rule 206(4)-8(a)(2)) lacks clarity as it does not provide advisers with direction as to what constitutes prohibited conduct. This lack of clarity would likely chill communications between advisers, their clients, and the Commission. While we make no specific recommendation with respect to what should constitute prohibited conduct, we encourage the Commission to provide advisers with notice of specific conduct that would constitute fraud under Rule 206(4)-8 and to approach the rule-making process with the following considerations in mind.

We note at the outset that, in our experience, the private fund industry is committed to eradicating fraud perpetrated against investors, and that those rules, such as Rules 206(4)-1 through 206(4)-7, that define prohibited conduct with specificity, provide advisers with either the ability to conform their practices accordingly or to explain why conformity is burdensome or impracticable. Without clarity in rule-making, enhancing compliance and promoting constructive dialogue with the Commission is extremely difficult to achieve.

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[2] Implications of the Growth of Hedge Funds, Staff Report to the United States Securities and Exchange Commission (September 2003).

[3] Id. at 100-101.

[4]The entire record relating to proposal and adoption of the rules relating to the registration of hedge fund advisers, which rules were overturned in Goldstein v. SEC 451 F.3d 873 (D.C. Cir. 2006), indicates that the Commission holds this view.

Adoption of the enabling provision of Section 206(4) of the Advisers Act evidences the importance Congress attached to clarity in rule-making as it granted the Commission only the authority to " define, and prescribe means reasonably designed to prevent, such acts, practices, and courses of business as are fraudulent, deceptive, or manipulative." Because of the broad, undefined character of Rule 206(4)-8(a)(2), we are concerned that the Proposed Rule falls outside this statutorily-defined authority.

We further believe that the lack of clarity in the Proposed Rule may lead to Staff interpretations that do not have the benefit of the formal rule-making process. As a result, there will, in effect, be informal rule making. This concern is heightened by the industry perception that SEC examinations of the books and records of registered advisers, conducted by the SEC's Office of Compliance, Inspections and Examinations ("OCIE"), sometimes leads to inconsistent interpretations from different regional offices. While we believe OCIE earnestly attempts to coordinate this process, our experience has shown that inconsistencies in interpretation remain. In addition, broad anti-fraud rules allow the Staff to conclude, without prior notice, that some practices should be eliminated or changed. We accept the fact that the Staff is well-intentioned in so concluding, but we believe that such informal rule-making does not provide sufficient notice to advisers. For example, although registered broker-dealers are required to maintain disaster recovery policies and gift and entertainment policies, there are no such Advisers Act requirements applicable to advisers. Nonetheless, the Commission expects registered advisers to maintain such policies and procedures. Similar expectations exist with respect to the maintenance of certain books and records (including emails) although not required by the Advisers Act.

Next, we recognize that general anti-fraud provisions are important for investor protection, as evidenced by Section 10(b) and Section 14(e) of the Securities Exchange Act of 1934. However, unlike the Proposed Rule, these and other general anti-fraud provisions require a showing of scienter to establish liability. We are concerned over the lack of a scienter requirement in the Proposed Rule.[5] On an intuitive level, we find it difficult to understand how an adviser could be found to have engaged in conduct that is "fraudulent, manipulative, or deceptive", without having an accompanying culpable mental state. Additionally, we fear that the absence of a scienter requirement will have a chilling effect on communications between advisers and their clients if advisers fear that their well-meaning communications with clients may lead to unanticipated fraud allegations under the Proposed Rule. In our experience, investment advisers recognize and take seriously allegations of fraud, including the prospect of reputational harm. Advisers may limit communications with clients to avoid these allegations if communications made in good faith could be viewed as fraudulent.

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[5] We acknowledge the Commission's citation to the D.C. Circuit's decision in <u>SEC v. Steadman</u>, 967 F.2d 636 (D.C. Cir. 1992) to support its assertion that Section 206(4) does not require a showing of scienter to establish liability; however, we have significant reservations with respect to the Commission's reliance on this lone decision to support its assertion because of the flaws in the <u>Steadman</u> court's analysis of Section 206(4) and its comparison with the wording of Section 206(2) of the Advisers Act and Section 17(a)(3) of the Securities Act. We believe that the wording of Section 206(4)--which is similar to that found in Section 14(e) of the Securities Exchange Act of 1934 which requires a showing of scienter to establish liability--evidences Congressional intent to impose a scienter requirement to demonstrate a violation of Section 206(4). Therefore, we believe that the Commission has exceeded the rule-making authority granted by Section 206(4) in adopting the Proposed Rule without a scienter requirement.

We are also concerned that the Proposed Rule's lack of a scienter requirement would adversely impact U.S. investors because the Proposed Rule would create disincentives for offshore investment advisers to seek U.S. clients (i.e. U.S. residents) to invest in their funds. Registered offshore investment advisers with U.S. clients are subject to all of the substantive provisions of the Advisers Act with respect to their U.S. clients. We believe that, in conducting a regulatory risk analysis, offshore investment advisers may come to the conclusion that the benefits of having U.S. clients as investors in their funds are outweighed by the possibility that they may stumble into unforeseeable enforcement actions, even if their conduct was not accompanied by a culpable mental state. This prospect would drastically limit the options available to U.S. investors seeking exposure to non-U.S. private investment funds.

Therefore, for the foregoing reasons, we urge the Commission to adopt measures that would protect investors while promoting transparency and including a scienter requirement in the Proposed Rule.

II. Proposed Rules 509 and 216

Proposed Rules 509 and 216 would raise investor accreditation standards by requiring that natural persons seeking to invest in private investment vehicles qualify as "accredited natural persons" having $2.5 million in qualifying investments in addition to satisfying the income or net worth requirements contained in Rule 501(a) under Regulation D.

We commend the Commission on its efforts to ensure that investors are sufficiently sophisticated to evaluate and bear the risks of an investment in a private investment vehicle, and we note our previous support for raising the investor accreditation standards.[6] We agree with the Commission that if the standards are to be revised for investors in private investment vehicles, a test based on investments is a better proxy for financial sophistication than a test based on an investor's net worth. However, for several reasons, we believe that the $2.5 million investment threshold is overly restrictive. When Regulation D was enacted, the Commission noted that the net worth threshold had been originally established at $750,000, but was raised, for the sake of simplicity, to $1,000,000 to reflect the inclusion of personal residences and other assets.[7] Because the $2.5 million investments test excludes personal residences from the definition of qualifying investments, we believe that the $750,000 amount is an appropriate starting point for making adjustments to the investor accreditation standards, and that the appropriate inflation-adjusted threshold should be set, for the sake of simplicity, at $1.5 million in investments (calculated using inflation rates adopted by the Commission's Office of Economic Analysis).

We do not believe that the five-year automatic adjustment for inflation is appropriate given the fact that the Commission has the rule-making authority to make future amendments to the investor accreditation standards if it finds that the accredited natural person test is insufficient to promote investor protection. We note that including an automatic adjustment provision in the Proposed Rules would also represent a marked departure from

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[6] Schulte Roth & Zabel LLP comment letter (September 15, 2004).

[7] Securities Act Release No. 33-6389 (March 8, 1982) at Section III.B.1.f.

comparable investor qualification provisions, such as the existing accredited investor test in Rule 501(a) under Regulation D, the qualified client test in Rule 205-3 under the Advisers Act, and the qualified purchaser test in Section 2(a)(51) of the Investment Company Act of 1940 (the "Company Act").

Additionally, we are concerned over the inequitable impact that the $2.5 million investment threshold would have on young, educated people who possess sufficient financial knowledge to understand the risks of investing in private investment vehicles but lack the quantity of qualifying investments to satisfy the accredited natural person standard. Although helpful in certain circumstances, the financial qualification standards do not represent a perfect proxy for financial sophistication as evidenced by the fact that many academicians and educators may be financially sophisticated, but lack a sufficient amount of investments to qualify as accredited natural persons.

We also do not believe that the heightened qualification standards should extend to investors in private investment vehicles advised by registered advisers. First, investors in most Section 3(c)(1) funds advised by registered advisers must be "qualified clients" as defined in Rule 205-3 under the Advisers Act, because most Section 3(c)(1) funds charge their investors a performance-based fee. In order for registered advisers to charge such fees, generally, their clients must have $750,000 in investments under management with the registered adviser or persons whom an adviser reasonably believes have at least $1.5 million in net worth. Therefore, investors in private funds advised by registered advisers are already subject to heightened financial qualification standards that we believe are sufficient to establish their financial sophistication and knowledge. Second, registered advisers are already subject not only to heightened investor disclosure standards as outlined in Rule 204-3 of the Advisers Act and other substantive provisions of the Advisers Act, but also to periodic OCIE examinations of their books and records. Accordingly, we recommend that investors in private investment vehicles advised by registered advisers remain subject to the existing accredited investor standards contained in Rule 501(a) under Regulation D. We believe that adopting this approach would have the added benefit of encouraging advisers to register with the Commission to make available a wider pool of investors eligible to invest in their funds. Registration, in turn, would provide the Commission with more information about and oversight of these fund managers.

We further suggest that the heightened investor qualification standards contained in Proposed Rules 509 and 216 should not apply to employees of advisers to private investment vehicles ("pool employees") and their immediate family members. We believe that financial qualification standards are an unnecessary proxy for measuring the financial sophistication of pool employees who have intimate familiarity with the workings of investment advisers and the funds they manage. The Proposed Rules would have a particularly harsh impact on pool employees because, in practice, many fund advisers have instituted policies and procedures which prohibit their employees from engaging in any personal investment activity except for making an investment in the employers' funds. Permitting pool employees to make an investment in funds managed by their employers is an important tool required for investment advisers to obtain and retain talented personnel--an asset that is critical to a private fund's success. Furthermore, permitting fund investments by pool employees also aligns the interests of pool employees with those of the funds which are advised by their employers.

More generally, we would support further liberalization of the rules relating to fund investments by employees, including those who do not constitute "knowledgeable employees" under the narrow definition contained in Rule 3c-5 under the Investment Company Act of 1940 (the "Company Act")[8]. We acknowledge that the Commission has previously declined to expand the definition of knowledgeable employees to cover marketing, investment relations, research, legal, brokerage, financial, compliance, operational and accounting professionals[9]; however, for the above-referenced reasons, we urge the Commission to reconsider this position. Although such pool employees do not all make executive-level decisions, we believe their interaction and integral involvement with their firms' decision makers provides them with access to sufficient information about fund risks and operations to make informed investment decisions.

As a practical matter, we note that investment professionals who do not qualify as knowledgeable employees are already being permitted to make indirect investments in their employers' funds through the creation of numerous parallel Section 3(c)(1) funds. This process, however, is extremely inefficient as it creates additional administrative work for the adviser. Additionally, the small size of many of these parallel Section 3(c)(1) funds prohibits them from participating in certain investments made by the investment adviser. For the foregoing reasons, we encourage the Commission to broaden the definition of knowledgeable employees as defined in Rule 3c-5 to permit pool employees to invest in funds managed by their employers.

Also, for the above reasons, we also endorse amendment of Rule 701 under the Securities Act to permit pool employees to invest in compensatory benefit plans established by their employers. As it currently reads, Rule 701 exempts from the Securities Act registration requirements certain compensatory benefit plans established by an issuer, its parent, or their subsidiaries for the benefit of certain qualifying employees and consultants. However, we note that most private funds do not have employees, as private funds are typically managed by investment advisers. The pool employees are employed by the adviser to the private fund. Therefore, Rule 701 is unavailable to most advisers because the adviser is not the issuer of the securities. We recommend that Rule 701 be amended to allow "affiliates" of an issuer to engage in offers and sales exempted by Rule 701.

We would also endorse reconsideration of the rules addressing the accredited investor status of irrevocable trusts. These trusts are a valuable estate planning tool used by wealthy and sophisticated investors to transfer wealth to their heirs. The definition of "qualified purchaser" contained in Section 2(a)(51) of the Company Act provides that an irrevocable trust with less than the required dollar amount of investable assets may nonetheless constitute a "qualified purchaser" if the settlor, and the trustee responsible for investment decisions, are themselves qualified purchasers. We believe that an entity that meets these tests should also qualify as an accredited investor, and should not be subject to the heightened qualification standards of Proposed Rules 509 and 216.

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[8] 17 C.F.R. § 270.3c-5.

[9] American Bar Association Section of Business Law, SEC No-Action Letter, 1999 WL 235450 (pub. avail. April 22, 1999).

We hope that our comments will assist the Commission in further refining the Proposed Rules and in pursuing its goals with respect to private funds. We would be pleased to discuss with you and other members of the Staff any aspect of this letter. Questions may be directed to Paul N. Roth at (212) 756-2450 or Stephanie Breslow at (212) 756-2542.

Very truly yours,

Schulte Roth & Zabel LLP