

## SEC PROPOSES NEW RULES

As we have discussed with many of you, in late December 2006, the Securities and Exchange Commission (“SEC”) released proposed new rules (the “Proposed Rules”) that would heighten the historic “accredited investor” eligibility requirements for natural persons who invest in investment funds. The Proposed Rules also include various amendments to the antifraud provisions of the Investment Advisers Act of 1940, as amended (the “Advisers Act”), that expand the SEC’s authority to regulate the activities of (and to bring enforcement actions against) fund managers.

This Alert addresses some of the questions raised by the Proposed Rules, many of which will likely be aired publicly as the SEC’s rulemaking process unfolds in the coming weeks. If adopted in their current form, the Proposed Rules would have the following application:

### Amendment to the “Accredited Investor” Definition

#### 1) To whom will the Proposed Rules apply?

The Proposed Rules apply to entities commonly known as hedge funds that are formed under Section 3(c)(1) of the Investment Company Act of 1940, as amended (the “Investment Company Act”), but not under Section 3(c)(7) of the Investment Company Act. The Proposed Rules also apply to other types of investment funds, but specifically do not apply to any fund that meets the definition of “business development company” under Section 202(a)(22) of the Advisers Act. This will exclude funds that actively participate in the management of portfolio companies, including certain venture capital and private equity funds.

#### 2) What is an “Accredited Natural Person” under the Proposed Rules?

The Proposed Rules would institute a new additional requirement that an individual or “natural person” would need to own at least \$2.5 million in “Investments” at the time of purchasing a Section 3(c)(1) fund’s securities. The \$2.5 million amount will be adjusted for inflation every five years. An “Accredited Natural Person” also would still need to (i) meet the current income or net worth test applicable to “Accredited Investors” by either (A) having a net worth of \$1,000,000 individually or with such person’s spouse, or (B) having individual income of \$200,000 in the most recent two years or \$300,000 of joint income with such person’s spouse.

#### 3) Will the Proposed Rules apply to sales by funds to entities?

We believe the Proposed Rules would apply to a natural person investing in a Section 3(c)(1) fund indirectly through an entity that (i) is formed for the purpose of making an investment in such fund or (ii) is an accredited investor solely by means of the accredited status of its owners.

#### 4) How do the Proposed Rules define “Investments”?

This definition is based on the current definition set forth in Rule 2a51-1 of the Investment Company Act (and applicable to Section 3(c)(7) funds) and the provisions therein that are relevant to a natural person. The term would, however, treat differently investments owned jointly with a spouse or that are part of a shared

community. An individual investor would be able to include only 50% of those investments in determining whether he or she meets the \$2.5 million requirement. The aggregate amount of investments would be measured by the fair market value of the investments on a per investment basis. Finally, the proposed definition would not include real estate that is used by a natural person or certain family members for personal purposes or as a place of business.

**5) Will the proposed definition apply to current investors?**

Under the Proposed Rules, an investor who is currently eligible as an Accredited Investor but does not meet the new Accredited Natural Person standard would be grandfathered as to existing investments in a Section 3(c)(1) fund at the time of adoption of the Proposed Rules. Such investors would not be grandfathered, however, with respect to additional investments in such funds.

**6) Is there a provision in the Proposed Rules with respect to the sale of securities to an employee of a fund manager that does not meet the definition of an “Accredited Natural Person”?**

No, but the SEC has requested comment as to whether it should add to the list of “Accredited Natural Persons” certain “Knowledgeable Employees” consistent with the concept of those employees currently eligible to invest in accordance with Rule 3c-5 under the Investment Company Act.

**7) How will the Proposed Rules affect a fund’s existing offering documents?**

Fund managers will need to review their documents closely to adjust applicable disclosure relating to eligible investors. In many instances, this will require adjustments to a fund’s private placement memorandum (or similar offering documents). Fund managers also will need to adjust their subscription documents and related investor questionnaires to obtain revised information from prospective investors.

**Proposed Antifraud Rules**

**1) What do the Proposed Rules provide regarding enhanced antifraud regulation?**

The SEC has proposed a new antifraud rule, Rule 206(4)-8 under the Advisers Act, that would make it a fraudulent, deceptive or manipulative act, practice or course of business for an investment adviser to a pooled investment vehicle to make false or misleading statements or otherwise defraud investors or prospective investors in that pool. Under the Proposed Rules, “pooled investment vehicles” would include hedge funds, mutual funds, private equity funds, venture capital funds and other types of privately offered pools. The proposed antifraud rule would apply to all advisers to pooled investment vehicles regardless of whether the adviser is registered under the Advisers Act. Advisers would be prohibited from making false statements in the context of an offering, such as statements made in private placement memoranda and side letters. The rule would not be limited to offering disclosure and would extend to statements made in documents such as the fund’s portfolio valuation, account information provided to investors, statements made in investor letters, the calculation of performance of the fund, and the allocation methods used by the adviser.

**General**

**1) Is the SEC accepting comments to the Proposed Rules?**

Yes. Comments on the Proposed Rules are due to the SEC on or before March 9, 2007. The full text of the Proposed Rules is available online at [www.sec.gov/rules/proposed/2006/33-8766.pdf](http://www.sec.gov/rules/proposed/2006/33-8766.pdf). We expect that the SEC will receive a large volume of comments to the Proposed Rules given the significance of these proposed changes. If you are interested in commenting on the Proposed Rules, we would be happy to assist you with the preparation of your comment letter.

**2) Following the comment period, what is the likely adoption date of the Proposed Rules?**

At this stage, it is unclear. Most experts agree, however, that the earliest date of adoption would be in mid-2007.

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If you have any questions regarding the foregoing, please contact one of the members of our Investment Fund Practice Group listed below.

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