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## SEC Proposes New Rules Regarding Fraud by Advisers to Pooled Investment Vehicles and Raising the Asset Minimum for "Accredited Investors" to \$2.5 million

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In December 2006, the Securities and Exchange Commission (the "SEC") proposed three new rules pertaining to pooled investment vehicles. [1] The first rule is for investment advisers to certain pooled investment vehicles prohibiting such advisers from making false or misleading statements or otherwise defrauding investors or prospective investors in those pools. The other two new rules would revise the definition of accredited investor as it relates to natural persons.

### I. Fraud by Investment Advisers to Pooled Investment Vehicles .

In response the Court of Appeals' opinion in Goldstein v. SEC [2] in 2006 that vacated the SEC's rule requiring certain hedge fund advisers to register under the Investment Advisers Act of 1940 (the "Advisers Act"), the SEC proposed to adopt Rule 206(4)-8 (the "Fraud Rule") to help eliminate confusion regarding the applicability of certain antifraud provisions of the Advisers Act [3] to investment advisers of pooled investment vehicles that defraud investors in those pools. The Fraud Rule would prohibit advisers to investment companies and other pooled investment vehicles from (i) making false or misleading statements to investors and prospective investors in those pools and (ii) otherwise defrauding such investors. The Fraud Rule, unlike the other anti-fraud provisions of Section 206 of the Advisers Act, would apply to both registered and unregistered investment advisers. The SEC is proposing to include only advisers of registered investment companies and investment companies that qualify for the exclusions provided by sections 3(c)(1) and 3(c)(7) of the Investment Company Act of 1940 (the "1940 Act").

The Fraud Rule would make it a fraudulent, deceptive, or manipulative act, practice or course of business for any investment adviser to make any untrue statement of material fact to any investor or prospective investor in the pooled investment vehicle, or to omit to state a material fact necessary in order to make the statements made to any investor or prospective investor in the pooled investment vehicle, in the light of the circumstances under which they were made, not misleading. Unlike Rule 10b-5 of the Securities Exchange Act of 1934 (the "Exchange Act"), the Fraud Rule does not require that the adviser act with scienter. The Fraud Rule also is not limited to fraud in connection with the purchase or sale of a security; it would also prohibit false or misleading statements including but not limited to those relating to investment strategies the fund will pursue, the experience and credentials of the adviser, the risks of investing in the fund, the performance of the fund and the valuation of the fund. Lastly, there is no private cause of action against an adviser under the Fraud Rule.

### II. Amendments to the definition of "Accredited Investor".

Under Rule 506 of Regulation D under the Securities Act of 1933 (the "Securities Act"), an issuer may sell its securities to an unlimited number of "accredited investors" without registering under the Securities Act, unless subject to another restriction. Rule 501(a) defines an "accredited investor" as a natural person whose individual net worth, or joint net worth with that person's spouse, at the time of his purchase exceeds \$1,000,000, or whose individual income exceeds \$200,000 (or joint income with the person's spouse exceeds \$300,000) in each of the two most recent years and who has a reasonable expectation of reaching the same income level in the year of investments. In light of inflation and the appreciation in

real estate since the net worth and income requirements were adopted in 1982, the SEC is proposing to add new rules 509 and 216 under the Securities Act (the "Natural Persons Rules") to include a new category of accredited investor that would apply to offers and sales of securities issued by investment pools qualify for the exclusion from registration provided by section 3(c)(1) of the 1940 Act ("3(c)(1) Pools"). The Natural Persons Rules would require a natural person to meet the definition of an accredited investor under Rule 501(a) or 215, as applicable, and would add a requirement that such person also must own (individually, or jointly with the person's spouse [4]) at least \$2,500,000 (as adjusted every five years for inflation) [5] in investments at the time of purchase to qualify as an "accredited natural person". Real estate held by a natural person for personal purposes, as a place of business or in connection with a trade or business may not be considered as an "investment" for purposes of determining whether such natural person has reached the \$2.5 million in investments requirement. 3(c)(1) Pools relying on section 4(6) or Rule 506 of the Securities Act could only treat a natural person as an accredited investor if such natural person also was an "accredited natural person".

The Natural Persons Rules would not grandfather in current accredited investors who would not meet the new accredited natural person standard so that they could make future investments in 3(c)(1) Pools, even those in which they are currently invested.

The SEC is also considering added an exemption from the definition of "accredited natural person" for employees of 3(c)(1) Pools and/or adding certain "knowledgeable employees" to the definition of "accredited natural person" consistent with the concept of "knowledgeable employees" eligible to invest in private investment pools under Rule 3c-5 of the 1940 Act.

The SEC has requested comment by March 9, 2007.

[1] SEC Release No. 33-8766 and IA-2576.

[2] Goldstein v. SEC, 451 F3d 873 (DC Cir. 2006) ("Goldstein")

[3] Sections 206(1) and 206(2) of the Advisers Act

[4] To determine if a natural person has \$2.5 million in investments, a 3(c)(1) Pool may only consider 50% of the investments held jointly with such person's spouse if the natural person is investing individually without such person's spouse. If the natural person is investing in the 3(c)(1) Pool jointly with such person's spouse, all the investments of the couple may be considered.

[5] The adjustment for inflation would be based upon the Personal Consumption Expenditures Chain-Type Price Index (or any successor index thereto) as published by the Department of Commerce.

For more information about these issues, please contact the author(s) of this Legal Alert or your existing firm contact.

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