SEWARD & KISSEL LLP

January 16, 2007

Memorandum to our Investment Management Clients and Friends

Proposed Rules Revising Criteria for the "Accredited Investor" Standard and Extending Anti-Fraud Provisions

On December 27, 2006, the Securities and Exchange Commission (the "Commission") proposed two new rules[1] under the Securities Act of 1933 (the "Securities Act"), which would create a new additional eligibility standard for natural persons investing in a fund that is excluded from the definition of an investment company pursuant to Section 3(c)(1) (a "3(c)(1) Pool") of the Investment Company Act of 1940 (the "Investment Company Act"). A 3(c)(1) Pool would include a hedge fund or a fund of hedge funds that relies on Section 3(c)(1) to be excepted from the definition of an investment company as opposed to Section 3(c)(7) of the Investment Company Act (a "3(c)(7) Pool"). The Commission also proposed a new rule[2] under the Investment Advisers Act of 1940 (the "Advisers Act"), that would clarify, in light of the recent *Goldstein* decision[3], the Commission's ability to bring enforcement actions under the Advisers Act against investment advisers who defraud the underlying investors or prospective investors in a hedge fund or other pooled investment vehicle.[4]

Proposed New Accredited Natural Person Standard

The Commission is proposing new rules under the Securities Act which would create a *new category of accredited investor, the "accredited natural person", which would apply to offers and sales of securities by 3(c)(1) Pools*[5] *and could significantly impact a 3(c)(1) Pool's ability to raise capital from natural persons*. The Commission is proposing these new rules based on its belief that the current definition of "accredited investor"[6] may not provide sufficient

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1 Proposed Rule 509 and Proposed Rule 216.

2 Proposed Rule 206(4)-8.

3 *Goldstein v. Securities and Exchange Commission* (451 F.3d 873 D.C. Cir. 2006). In August 2006, the Court of Appeals for the D.C. Circuit vacated a rule adopted by the Commission in 2004 which required certain hedge fund advisers to register with the Commission under the Advisers Act. The court in *Goldstein* expressed the view that, for purposes of Sections 206(1) and (2) of the Advisers Act, the "client" of an investment adviser managing a pool is the pool itself and not the investors in that pool. The Commission stated its belief that the *Goldstein* decision created uncertainty with respect to obligations that an investment adviser to a pooled investment vehicle has to the pool's underlying investors under the anti-fraud provisions of the Advisers Act and it is therefore proposing this new rule.

4 Copies of the release may be obtained on the web at www.sec.gov/rules/proposed/2006/33-8766.pdf.

5 The proposed new rules would not apply to a 3(c)(1) Pool that is a "venture capital fund." A "venture capital fund" has the same meaning as a business development company in Section 202(a)(22) of the Advisers Act.

6 Currently, under Rule 501(a)(5) and (6) of the Securities Act, a natural person will qualify as an "accredited investor" if he, either, (a) has an individual net worth, or a joint net worth with that person's spouse, in excess of $1,000,000 at the time of such person's purchase of securities in a pooled investment vehicle, or (b) had an individual income in excess of $200,000 in each of the two most recent years or joint income with that person's

protection for natural persons, due to the complexity and risks involved in investing in 3(c)(1) Pools. This additional accredited natural person standard would not apply to investors in a 3(c)(7) Pool or other investment vehicles operating pursuant to any other exemptions (other than Section 3(c)(1)) under the Investment Company Act.

Under the proposed rules, the following would apply:

- The current accredited investor standard would remain unchanged. Natural persons would have to be both accredited investors and accredited natural persons prior to investing in a 3(c)(1) Pool.

- A natural person will be required to own (individually, or jointly with the person's spouse) not less than $2.5 million in "investments" (the "Investment Threshold") at the time of purchasing interests in 3(c)(1) Pools.

- In determining whether a natural person meets the Investment Threshold, he would have to deduct the amount of any outstanding indebtedness incurred to acquire the investments and could only include up to fifty percent (50%) of any investments held jointly with that person's spouse. In addition, investments would be valued based on their fair market value.

- The value of a natural person's personal residence or place of business or real estate held in connection with a trade or business would not be includable in calculating the Investment Threshold.

- The Investment Threshold would be adjusted for inflation every five years.

- Existing investors in 3(c)(1) Pools would not be grandfathered and, therefore, will be required to meet the Investment Threshold at any time they purchase additional securities although they would be allowed to retain their existing investment in the 3(c)(1) Pool.

- All other provisions of the current rules under Regulation D (including provisions allowing for up to 35 non-accredited sophisticated purchasers to invest in a 3(c)(1) Pool[7]) would still apply.

- Employees of an adviser who do not meet the definition of an accredited natural person, even though they may be "knowledgeable employees", may have to use the non-accredited sophisticated purchaser slots to avail themselves of such investments.

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spouse in excess of $300,000 in each of those years and has a reasonable expectation of reaching the same level of income in the current year.

[7] Rule 506 under the Securities Act.

Proposed Extension of Anti-Fraud Provisions

The Commission is also proposing a new rule under Section 206(4) of the Advisers Act in light of *Goldstein*[8] which would make it a fraudulent, deceptive or manipulative act, practice or course of business for any registered or unregistered investment adviser to a pooled investment vehicle to (i) make any false or misleading statements or omit to state a material fact necessary to make the statements made not misleading, to any investor or prospective investor in such pooled investment vehicle, or (ii) otherwise defraud any investor or prospective investor in the pooled investment vehicle. The Commission would have the ability to enforce this proposed rule through administrative and civil actions against advisers under Section 206(4) of the Advisers Act. The type of pooled investment vehicles that are subject to this proposed rule would be any investment company as defined in Section 3(a) of the Investment Company Act, any 3(c)(1) Pool and any 3(c)(7) Pool. The new rule would apply to any materials or statements prepared or made by an adviser to any prospective or existing investor regardless of whether the pool is offering, selling or redeeming securities, including, any false or misleading statements made to existing investors in account statements or letters to investors or to prospective investors in private placement memoranda or offering circulars. The Commission pointed out that, unlike violations of Rule 10b-5 under the Securities Exchange Act of 1934, it need not demonstrate that an adviser violating the proposed rule acted with scienter in order to commence an enforcement action against an adviser.[9] The Commission did note, however, that the proposed rule would not create a fiduciary duty to investors or prospective investors in a pooled investment vehicle not otherwise imposed by law, and that it would not grant any private right of action against an adviser under the Advisers Act.

Comment Period

The Commission has requested comments on the proposed rules and related rule amendments by March 9, 2007.

If you have any comments or questions regarding the foregoing, please contact your primary attorney in the Investment Management Group at Seward & Kissel LLP.

Seward & Kissel LLP

[8] See footnote 3.

[9] We note that a violation by an adviser of any provision of Section 206(4) would not require a finding of scienter in order for the Commission to take an enforcement action against such adviser.