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Nancy M. Morris
Secretary
U. S. Securities and Exchange Commission
Station Place
100 F Street, NE
Washington, D.C. 20549-1090

Re: Accredited Investors in Certain Private Investment Vehicles; Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles (File No. S7-25-06)

Dear Ms. Morris:

The Investment Company Institute[1] strongly supports the proposed rules under the Securities Act of 1933 (the "Securities Act") that will require natural persons to own $2.5 million of investments to invest in certain private pools, including hedge funds.[2] This requirement is a reasonable way of assuring that private pools are only available to persons that have the ability to understand and bear the risks associated with a private pool.

The Institute also strongly believes that investors deserve, and will benefit from, continued vigilant Commission oversight of investment advisers. We fully support the Commission's ability to take tough enforcement measures against investment advisers who defraud their clients.[3] For the reasons set forth below, however, we question whether the proposed new antifraud rule is necessary to improve the Commission's ability to enforce antifraud standards against investment advisers with respect to their management of registered investment companies.[4] While we understand the

[1] The Investment Company Institute is the national association of the U.S. investment company industry. More information about the Institute is available at the end of this letter.

[2] *See* SEC Release No. IA-2576 (December 27, 2006); 72 FR 400 (January 4, 2007) (the "Release").

[3] The Institute strongly supported the Commission's proposal to require advisers to hedge funds to register under the Investment Advisers Act of 1940 (the "Advisers Act"). We particularly recognized the importance of the Commission's ability to inspect these advisers, which would permit the Commission to proactively address – not reactively respond to – potentially fraudulent activities in the hedge fund arena. *See* Letter from Elizabeth R. Krentzman, General Counsel, Investment Company Institute, to Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission, dated September 15, 2004.

[4] The proposed rule applies to investment advisers to all pooled investment vehicles. We use the terms "hedge fund advisers" and "registered fund advisers" in a functional way to refer to their activities with respect to particular funds.

Commission's desire to reassert the antifraud standards that it believes may have been called into question by the *Goldstein*[5] decision, we do not fully understand how the Commission staff will use the proposed antifraud standards in the future, particularly in the course of inspections and enforcement actions. We recommend that the Commission either not apply the rule to registered fund advisers, or explain in its adopting release the specific conduct the Commission intends to pursue under the rule that it is unable to effectively address today.

Accredited Natural Persons

Under the proposal, natural persons will be able to purchase interests in certain private pools[6] only if, among other requirements, they own at least $2.5 million in investments.[7] The Institute strongly supports this approach. As confirmed recently by The President's Working Group on Financial Markets, private pools should be available only to investors with the sophistication to identify, analyze, and bear the risks of investing in complex, illiquid, or opaque investments.[8] We agree that the proposed requirements meet this objective and also respond to the Commission's concern that inflation and growth in wealth, particularly due to the increased value of personal residences, has inappropriately made a substantial number of investors eligible to invest in private pools.[9]

Under the proposal, the $2.5 million investment requirement would not apply to natural persons investing in venture capital funds. We disagree with this exclusion. We believe that investors in venture capital funds should have the same level of financial sophistication and ability to bear economic risk as investors in other private pools. Their ability to bear economic risk is particularly important because investors in venture capital pools typically must agree to maintain a particular level of investment for several years, thus sacrificing the investment's liquidity for an extended period of time. Accordingly, to assure the continued protection of these investors, we recommend that the Commission require investors in venture capital funds to meet the same standards as those proposed for other private pools.

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[5] *Goldstein v. Securities and Exchange Commission*, 451 F.3d 873 (D.C. Cir. 2006).

[6] The Commission has proposed the new investment standard for investors in issuers that rely on Section 3(c)(1) of the Investment Company Act ("private pools").

[7] Persons investing in private pools are also subject to net worth and income requirements.

[8] *See* Agreement Among PWG and U.S. Agency Principals on Principles and Guidelines Regarding Private Pools of Capital (February 2007).

[9] The Institute also supports the proposed treatment of real estate, which would not be counted as part of a person's investments. The value of a person's personal residence or place of business, or real estate held in connection with a trade or business, does not necessarily reflect a person's knowledge and financial sophistication with respect to investing and, therefore, should be not be counted as a part of investments.

Rule 206(4)-8 under the Investment Advisers Act

Section 206(4) gives the Commission rulemaking authority to "define, and prescribe means reasonably designed to prevent, such acts, practices, and courses of business as are fraudulent." Under this authority, the Commission has proposed Rule 206(4)-8, which contains two fraud standards relating to investment advisers – a material misstatement or omission standard, and a general antifraud standard.[10]

Material Misstatements and Omissions. The first standard in the proposed rule makes it fraudulent for fund advisers to make material misstatements or omissions to existing or prospective fund investors. We question whether this provision is necessary for registered fund advisers. Section 34(b) of the Investment Company Act already expressly prohibits registered fund advisers from making material misstatements or omissions in prospectuses, shareholder reports, advertisements, account statements, proxy statements, and *any other* document filed, transmitted, or kept as a record under the Investment Company Act.[11] The Commission has not explained, nor have we been able to identify, the circumstances under which a registered fund adviser will violate the proposed material misstatement or omission standard without also violating Section 34(b) of the Investment Company Act.[12] Moreover, the Commission has not demonstrated any shortcoming in the coverage or usefulness of Section 34(b) that needs to be addressed.

General Antifraud Provision. The second standard in the proposed rule is a general antifraud provision that prohibits advisers from "otherwise" engaging in fraudulent activities with respect to existing or prospective investors. As indicated above, the Institute fully supports the Commission's ability to protect investors from fraud. We have several concerns, however, with the proposed provision including whether it is consistent with the Commission's rulemaking authority under Section 206(4) of the Advisers Act, whether it is necessary for registered fund advisers, and how it will be used in practice.

The language of Section 206(4) and its legislative history indicate that Congress intended to prohibit advisers from engaging in fraudulent activities in a way that was not limited by common law concepts of fraud and permit the Commission, by rule, to define and prescribe means reasonably

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[10] The Commission has made clear that there is no private right of action against an adviser under the proposed rule. We strongly support this approach, which is consistent with the Supreme Court's interpretation of the Advisers Act. *See* Transamerica Mortgage Advisors, Inc. v. Lewis, 444 U.S. 913 (1978) (finding that other than a right to void an adviser's contract, the Advisers Act confers no private causes of action).

[11] The Commission regularly exercises its authority under Section 34(b). *See e.g.*, *In the Matter of Kelmoore Investment Company, Inc.*, File No. 3-12541 (Jan. 18, 2007) (where the Commission found that the adviser willfully violated section 34(b) of the Investment Company Act by making material misstatements in fund prospectuses that made it difficult for investors to understand the amount they were paying for advisory fees or to make informed investment decisions when comparing the funds to other funds).

[12] In the Release, the Commission recognizes that "as a general matter, most advisers that advise registered investment companies will, to a large extent, communicate with investors and prospective investors in those funds through documents filed, transmitted, or kept as a record." Release at note 25.

designed to prevent fraudulent activities. Congress provided, as an example, that Section 206(4) would allow the Commission to address problems such as when an adviser has a "material adverse interest" in securities that it is recommending to its clients.[13]

Consistent with the statutory language and legislative history of Section 206(4), the Commission has exercised its Section 206(4) rulemaking authority to date by crafting rules that either define a particular practice as unlawful unless specific requirements are met or require advisers to implement procedures to protect against committing fraud. Shortly after Section 206(4) was enacted in 1960, for example, the Commission engaged in a study of investment advisory practices "which may be considered to be fraudulent, deceptive, or manipulative, with a view to adopting rules and regulations designed to prevent such acts and practices."[14] This study resulted in the adoption of Rule 206(4)-1, which forecloses the use of advertisements that have a tendency to mislead investors.[15] Subsequent rules under Section 206(4) similarly addressed particular behaviors that were of concern to the Commission.[16]

The antifraud standard proposed in Rule 206(4)-8(a)(2) departs from Congress's statutory mandate and the prior rules adopted by the Commission under Section 206(4). As proposed, we believe the generality of the rule raises the strong possibility that it is susceptible to being overturned upon challenge in the courts.

In addition, we question whether proposed Rule 206(4)-8(a)(2) is necessary for registered fund advisers in light of the Commission's extensive existing authority in this area. Registered fund advisers are subject to a variety of fraud standards, including Sections 11, 12 and 17 of the Securities Act, Section 10(b) of and Rule 10b-5 under the Securities Exchange Act of 1934, Section 34(b) of the Investment Company Act (as noted above), Sections 206(1), 206(2) under the Advisers Act and the full panoply of rules adopted pursuant to Section 206(4) of the Advisers Act. Given the Commission's existing authority, the new standard is redundant with respect to registered fund advisers.

This redundancy leads to uncertainty about the conduct that the new standard will be used to address. As with any antifraud rule, the way the inspection and enforcement staff will use it will depend

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[13] *See* S.Rep. No. 1760 (June 28, 1960).

[14] *See* IA Rel. No. 113 (April 4, 1961) (proposing Rule 206(4)-1).

[15] *Id.*; IA Rel. No. 119 (August 8, 1961) (revising the proposal); and IA Rel. No. 121 (November 2, 1961) (adopting Rule 206(4)-1).

[16] Rule 206(4)-2 (regulating adviser custody of client funds and securities); Rule 206(4)-3 (regulating adviser cash payments for cash solicitations); Rule 206(4)-4 (requiring advisers to disclose certain financial and disciplinary information to clients); Rule 206(4)-6 (regulating adviser proxy voting); and Rule 206(4)-7 (requiring advisers to have chief compliance officers and compliance policies and procedures). All of the rules adopted under Section 206(4) to date apply to registered fund advisers but not to hedge fund advisers.

on a combination of Commission and staff speeches, exam protocols, and settled cases, and – in rare instances – judicial decisions. It is impossible to predict exactly how this law and lore will develop, particularly given the Commission's decision not to require a finding of scienter for a violation of the rule.

We request that the Commission explain how the proposed rule is consistent with its authority under Section 206(4) of the Advisers Act. We also recommend that the Commission either not apply the rule to registered fund advisers, or explain in the adopting release the specific, additional conduct the Commission intends to pursue under the proposed standard.

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We consider this an important rulemaking effort and appreciate the opportunity to provide you with our comments. If you have any questions or would like additional information, please contact me at (202) 326-5815, Robert C. Grohowski at (202) 371-5430, or Dorothy M. Donohue at (202) 218-3563.

Sincerely,

/s/ Elizabeth Krentzman

cc: The Honorable Christopher Cox
The Honorable Paul S. Atkins
The Honorable Roel C. Campos
The Honorable Annette L. Nazareth
The Honorable Kathleen L. Casey

Andrew J. Donohue, Director, Division of Investment Management
Robert E. Plaze, Associate Director, Division of Investment Management

U.S. Securities and Exchange Commission

About the Investment Company Institute

ICI members include 8,839 open-end investment companies (mutual funds), 658 closed-end investment companies, 363 exchange-traded funds, and 4 sponsors of unit investment trusts. Mutual fund members of the ICI have total assets of approximately $10.445 trillion (representing 98 percent of all assets of US mutual funds); these funds serve approximately 93.9 million shareholders in more than 53.8 million households.

Many of the Institute's investment adviser members render investment advice to both investment companies and other clients. In addition, the Institute's membership includes 153 associate members, which render investment management services exclusively to non-investment company clients. A substantial portion of the total assets managed by registered investment advisers is managed by these Institute members and associate members.