SECURITIES NEWS

The Securities Law Practice Group at Murtha Cullina LLP is pleased to provide its clients and friends with information about topics of interest in the securities regulation area.

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SEC PROPOSES ANTI-FRAUD AND ELIGIBILITY RULES FOR HEDGE FUNDS AND OTHER POOLED INVESTMENT VEHICLES, ADOPTS NEW INTERNET PROXY RULES

At a lengthy open meeting held on December 13, 2006 (the "Open Meeting"), the Securities and Exchange Commission (the "SEC") voted to take action on a half dozen rulemakings prepared by the SEC's Division of Corporation Finance. Two of these rulemakings are discussed below. First, the SEC voted unanimously to propose new rules that would prohibit investment advisers to pooled investment vehicles from making false or misleading statements or otherwise defrauding investors or prospective investors in those pooled investment vehicles. The new rules would also revise the definition of "accredited investor" under the Securities Act of 1933 (the "Securities Act") as it relates to natural persons, but solely in the context of the offer and sale of interests in "private investment vehicles" defined in the proposed rules.

Second, the SEC adopted amendments to the proxy rules under the Securities Exchange Act of 1934 establishing a new "notice and access" model for making proxy materials electronically available to shareholders on an internet website as an alternative to traditional delivery methods. The new "e-proxy" model for furnishing proxy materials is intended to substantially decrease the mailing expenses incurred by public companies and provide other soliciting persons with a more cost-effective means to undertake proxy solicitations. The final rules are substantially similar to the rules first proposed by the SEC in late 2005. The new rules will not apply, however, to the 2007 annual meeting proxy season.

I. Proposed Anti-Fraud and Eligibility Rules for Hedge Funds and Other Pooled Investment Vehicles

The proposed new rules relating to hedge funds and other pooled investment vehicles were published in the Federal Register on December 27, 2006. *See Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles; Accredited Investors in Certain Private Investment Vehicles; Proposed Rule*, Securities Act Rel. No. 33-8766, 72 Fed. Reg. 400 (Jan. 4, 2007). They are subject to a public comment period ending on March 3, 2007.

Proposed Anti-Fraud Rule 206(4)-8. A recent federal appeals court decision, Goldstein v. SEC, 451 F.3d 873 (D.C. Cir. 2006), vacated an SEC rule requiring many hedge fund advisers to register under the Investment Advisers Act of 1940 (the "Advisers Act"), and in so doing, had cast doubt on the SEC's ability to bring enforcement actions under the Advisers Act against investment advisers who defraud investors or prospective investors in hedge funds or other pooled investment vehicles.

Proposed Rule 206(4)-8 under the Advisers Act would eliminate the doubt by expressly prohibiting false or misleading statements of material facts and any other type of fraudulent activity by both registered and unregistered investment advisers to current or prospective investors in pooled investment vehicles. The proposed Rule would apply regardless of whether the investment pool was offering, selling or redeeming its securities and would prohibit false or misleading statements made to existing investors in account statements or other communications and any such statements made to prospective investors in private placement memoranda, offering circulars and similar documents. The proposed Rule would be broadly applicable to "pooled investment vehicles," including those "investment companies" offered to the public and those entities exempt from the "investment company" definition by virtue of Sections 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940 (the "Company

Act") – such as hedge funds, private equity funds, venture capital funds, and other types of privately-offered pooled vehicles that invest in securities.

The proposed Rule would not be limited to fraud in connection with the purchase and sale of a security, and could be read as applying broadly to the "non-advisory" conduct of an investment adviser, such as action taken by the investment adviser or an affiliate as the general partner or manager of a limited partnership or limited liability company, so long as the conduct is related to current or prospective investors.

If adopted, the proposed Rule would be enforced by the SEC through administrative and civil actions against investment advisers under Section 206(4) of the Advisers Act. Under the proposed Rule, the SEC would not need to demonstrate that an investment adviser acted with "scienter" (an intent to defraud) in order to establish a violation of the Rule. The SEC stated that the Rule, if adopted, would not create a new implied private right of action under the Advisers Act for parties other than the SEC and would not create any new or additional fiduciary duties to existing or prospective investors not otherwise imposed by law.

. . . . the SEC has proposed a new "accredited investor" standard for natural persons under Sections 4(2) and 4(6) of the Securities Act solely with respect to investments in "private investment vehicles," as defined under the proposed Rules.

Proposed Accredited Natural Person Definition Under the Securities Act. Private offerings of securities issued by investment pools are generally made without compliance with the registration requirements of Section 5 of the Securities Act in reliance on the private offering exemption provided by Section 4(2) of the Securities Act or in compliance with certain rules adopted under that section, typically Regulation D. Rule 506, one of the "safe harbor" rules of Regulation D, provides objective standards that issuers of securities can satisfy to meet the requirements of the statutory Section 4(2) private offering exemption. According to the SEC, privately offered investment pools typically rely upon Rule 506 to exempt the offer and sale of their securities to accredited investors. For purposes of Rule 506, the term "accredited investor" has been defined since 1982 to include a natural person whose individual net worth, or joint net worth with the person's spouse, exceeds $1,000,000 at the time of the purchase, 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 investment. A similar definition has applied under Section 4(6) of the Securities Act pursuant to Rule 215.

As a result of market changes in the private offering area, increases in investor wealth and the effects of inflation, the number of "accredited investors" in the United States has significantly increased since the 1980s. Accordingly, the SEC believes the current net worth and income tests should be augmented to ensure that they provide an "objective and clear standard to use in ascertaining whether a purchaser of a private investment vehicle's securities is likely to have sufficient knowledge and experience in financial and business matters to enable that purchaser to evaluate the merits and risks of a prospective investment."

For these reasons, the SEC has proposed a new "accredited investor" standard for natural persons under Sections 4(2) and 4(6) of the Securities Act solely with respect to investments in "private investment vehicles," as defined under the proposed Rules. Under proposed Rules 216 and 509, a new category of investor – called "accredited natural person" – would be defined for investments in "private investment vehicles." The definition of "private investment vehicle" would include only those issuers that are exempt from registration as investment companies by virtue of Section 3(c)(1) of the Company Act ("3(c)(1) Pools"). The term would exclude those entities relying on Section 3(c)(7) of the Company Act to avoid SEC registration as an "investment company" (which may only offer investments to natural persons meeting the $5 million/qualified purchaser standard). The definition would also exclude venture capital funds, which would be defined to have the same meaning as a "business development company" under Section 202(a)(22) of the Advisers Act.

As proposed, the "accredited natural person" standard would include any natural person who satisfies the current Rule 215/Rule 501 definition of an accredited investor, as that term relates to natural persons, but would also require that such person must own (individually, or jointly with the person's spouse) not less than $2.5 million (as adjusted every five years for inflation, beginning on April 1, 2012)

in investments at the time of purchase of the securities being issued by the 3(c)(1) Pool. Because the proposal would not alter the existing Rule 215/Rule 501 definition of an "accredited" investor, natural persons would have to satisfy the new "two step" approach in order to invest in 3(c)(1) Pools under Regulation D or Section 4(6).

The proposed "accredited natural person" standard would be applied at the time the investor makes an investment in the 3(c)(1) Pool. The SEC noted, and sought comment on, the fact that the proposed Rules would not "grandfather" 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 currently are invested. However, a person not meeting the standard could maintain his or her existing investments. The SEC also solicited comment on whether employees of a 3(c)(1) Pool or its investment adviser should also be included within the definition of an "accredited natural person."

Under the proposed Rules, the term "investments" would include securities, real estate and physical commodities held for investment purposes, financial contracts to the extent that they are not securities, and cash and cash equivalents held for investment purposes. However, real estate would not qualify as an "investment" if it is used for personal purposes (such as in the case of a residence), as a place of business or in connection with a trade or business. Indebtedness incurred to acquire the investments must be deducted in satisfying the $2.5 million test. In addition, the value of a natural person's investments would be determined based on their fair market value as of a recent practicable date.

Unlike the current accredited investor standard, the proposed Rules would provide that a married individual making an investment on his or her own behalf (and not jointly with his or her spouse) would only be allowed to include fifty percent of his or her joint holdings in determining whether he or she is an "accredited natural person." Where both spouses are investing together, the full amount of all of their investments (whether made jointly or separately) would be included for purposes of determining whether each spouse is an "accredited natural person."

The SEC's proxy rule amendments will allow public companies and other soliciting persons to use a "notice and access" delivery model to post their proxy materials on a website and send a notice to shareholders of the availability of the material.

II. E-Proxy Final Rules

New "Notice and Access" Model. The SEC's proxy rules amendments will allow public companies and other soliciting persons to use a "notice and access" delivery model to post their proxy materials on a website and send a notice to shareholders of the availability of the material. The use of the notice and access model would be entirely voluntary for issuers and other soliciting persons wishing to rely on the new rules. The "notice and access" model would operate as follows for an issuer conducting a proxy solicitation.

First, the issuer would post its proxy materials on a publicly accessible internet website, other than the SEC's own EDGAR website. Second, the issuer would deliver a "Notice of Internet Availability of Proxy Materials" (the "Notice") to shareholders 40 days or more before the shareholder meeting to which the proxy materials relate. The Notice would have to include:

- a prominent legend in bold-face type advising shareholders of the date, time and location of the shareholder meeting;
- the address of the internet website (which must be operational prior to the sending of the Notice) where shareholders can access the issuer's proxy materials;
- a toll-free phone number, e-mail address and website that shareholders can use to request copies of the proxy materials, at no cost to the shareholder; and
- a clear and impartial description of the matters to be considered at the meeting, along with the issuer's recommendations regarding those matters.

The new Rules may permit additional information – such as a state law legend – to be included in the Notice. The Notice would have to be written in "Plain English" and could not contain any information beyond the information permitted by SEC rules. An issuer could not deliver any other shareholder communication along with the Notice to ensure that the Notice is given prominence and

does not get lost among several other types of communications. Concurrently with delivery of the Notice, the issuer must provide shareholders with one or more methods to vote their shares, which could include electronic voting over the internet and telephone voting, or a combination of various methods of voting. A proxy card may not accompany the Notice – but may be delivered 10 days after the initial delivery of the Notice if accompanied by a second copy of the Notice.

Shareholder Delivery Method Requests. Shareholders may request paper or e-mail delivery of the proxy materials. In order to do so, shareholders will be permitted to make a one-time permanent election to receive proxy materials on paper or by email with respect to future proxy solicitations by the company or by soliciting persons. Following each shareholder request, the company must send a copy of the proxy materials within three business days after receiving the request.

Beneficial Ownership. The "e-proxy" model would operate in a similar manner with respect to the delivery of proxy materials to beneficial owners whose securities are held by broker and bank intermediaries. An intermediary would create its own Notice to be delivered to beneficial owners, deliver the Notice to them, respond to requests for paper copies of proxy materials from beneficial owners and process the proxy voting instructions returned by beneficial owners. Beneficial owners may also request that an intermediary forward paper or e-mail copies of the proxy materials for all future shareholder meetings for all securities held in his or her account with that intermediary.

Other Soliciting Persons. A soliciting person other than the company may follow the notice and access model in substantially the same manner as a company, whether or not the company itself has adopted the "e-proxy" model for its own solicitation activities. However, its Notice must be sent to shareholders by the later of 40 days before the meeting or 10 days after the company filed its proxy materials. It may limit its solicitation to shareholders who have not previously requested paper or e-mail copies. But if the soliciting person sends a Notice to a shareholder, it must also send that shareholder a paper or e-mail copy upon request.

III. Effective Dates of the E-Proxy Rules; Proposed Mandatory Rules

The SEC's proxy rules amendments will not become effective until July 1, 2007. Early voluntary compliance with the new proxy rules will not be permitted. Thus, the amended rules will generally become available for the 2008 proxy season for calendar year-end companies.

In addition to the rule amendments described above, the SEC approved the issuance for public comment of proposed proxy rules to require (as early as the 2008 proxy season) public companies and other soliciting persons to follow the "notice and access" model for all solicitations not related to business combination transactions. The proposed mandatory model would operate in substantially the same manner as the voluntary model described above, but the notice could be accompanied by a full set of proxy materials.

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The full text of the SEC's proxy rules amendments has not yet been released, but the rules are described in the SEC's December 13, 2006 press release (available at http://www.sec.gov/news/press/speecharchive/2006speech.htm) and related statements of the Commissioners and the SEC staff at the December 13, 2006 Open Meeting (available at: http://www.sec.gov/news/speech/speecharchive/2006speech.shtml). The text of the SEC's December 27th proposed anti-fraud and eligibility rules for hedge funds and other pooled investment vehicles are publicly available at: http://www.sec.gov/rules/proposed/2006/33-8766.pdf.

The foregoing summary is intended to provide an overview of the SEC's proposed anti-fraud and eligibility rules for hedge funds and other pooled investment vehicles and the SEC's e-proxy rules amendments and proposals. If you have questions concerning the scope, application or implications of these rulemakings, or would like specific advice concerning the SEC's proposed rules or the e-proxy rules amendments, please contact any member of the Murtha Cullina LLP Securities Law Practice Group.

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