MANAGED FUNDS ASSOCIATION

April 3, 2006

VIA E-MAIL

Ms. Nancy M. Morris
Federal Advisory Committee Management Officer
Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549-1090

Re: File No. 265-23:
Exposure Draft of Final Report of Advisory Committee on Smaller Public Companies

Dear Ms. Morris:

Managed Funds Association ("MFA") appreciates the opportunity to make this submission of comments on Release Nos. 33-8666 and 34-53385 (the "Release") by the Advisory Committee on Smaller Public Companies (the "Committee") associated with the Securities and Exchange Commission ("SEC").

MFA is the only U.S.-based global membership organization dedicated to serving the needs of those professionals throughout the world who specialize in the alternative investment industry, including hedge funds, commodity pool operators, funds of funds and managed futures funds. MFA's over 1,000 members include professionals from the majority of the 50 largest hedge funds, which manage a significant portion of the estimated $1.5 trillion in assets under management currently invested with hedge funds.

There are many important issues raised by the Release, and MFA is confident that there will be a number of thoughtful and important comments submitted to the Staff. Accordingly, MFA wishes only to express its views on the three points raised in the Release which MFA believes to be of extreme importance to its constituents: (i) the Committee's suggestion of relaxing the private placement "manner of offering restrictions" with respect to offerings to "qualified purchasers," which MFA believes will facilitate capital formation without raising concerns over investor protection; (ii) the proposal to mitigate the application of Section 404 of the Sarbanes-Oxley Act[1] to "smaller public companies," which MFA believes should be

[1] Pub. L. No. 107-204, 116 Stat. 745 (July 30, 2002).

extended to public commodity pools; and (iii) the suggestion that "held of record" for purposes of applying Section 12(g) of the Securities Exchange Act of 1934 (the "1934 Act") be expanded to include beneficial rather than simply legal ownership, which, if implemented, would dramatically increase the number of our members that would be required to register under the 1934 Act, many of which would be forced to liquidate due to the added regulatory burdens this would create.

I. "Manner of Offering" Restrictions

Recommendation IV.P.5 suggests that a new private offering exemption be adopted which removes the Rule 502(c) prohibition on general solicitation and offering for investors who do not need all the protections of the Securities Act of 1933 (the "Securities Act").

The Release underscores the widespread confusion as to the scope of permissible solicitation in private offerings (commenting with tactful understatement, that "few bright-line tests exist").[2] The Release proposes a limited relaxation of the restrictions of 502(c) in the case of offerings to certain "eligible purchasers who do not require the full protection afforded by the securities registration process."[3] MFA fully supports this approach, and wishes to emphasize its applicability to the offering of private investment vehicles ("Private Investment Vehicles") to the elite group of investors which meet the "Qualified Purchaser" standard of Section 3(c)(7) of the Investment Company Act of 1940 (the "Company Act").[4] Congress has by statute determined that Qualified Purchasers (a much higher standard of eligibility than is suggested in the Release) do not need the protections of the federal securities laws, making the rationale set forth in the Release even more applicable to these investors than in the context presented in the Release itself.

The "manner of offering" restrictions of Rule 502(c) have long been a matter both of subjective judgment and lack of clarity.[5] The SEC no-action letters on the subject of what constitutes a permissible "manner of offering" in a private placement have emphasized the need of the issuer or the selling agent to have a "pre-existing substantive relationship" with the offeree.[6] This begs the question of how a private issuer or a selling agent could contact any new clients for possible private placement investments, especially as the SEC no-action letters commented that it was not possible to establish any such pre-existing substantive relationship in the course of or in anticipation of a private offering.[7] Interpreted literally, it is not possible to comply with this requirement in the context of an open-ended, continuous offering; even the most conservative investment firms have settled for allowing solicitation to begin after an

---

[2] Release at 90.
[3] Release at 71.
[4] Release at 72.
[5] For "manner of offering" issues in general, see David B.H. Martin, Jr., and L. Keith Parsons, *The Pre-existing Relationship Doctrine under Regulation D: A Rule Without a Reason*, 45 WASH. & LEE L. REV. 1031 (1988); Patrick Daugherty, *Rethinking the Ban on General Solicitation*, 38 EMORY L.J. 67 (1989).
[6] *See, e.g.*, *Bateman, Eichler, Hill Richards, Inc.* (pub. avail. Dec. 3, 1985); *E.F. Hutton Co.* (pub. avail. Dec. 3, 1985); *IPONET* (pub. avail. July 26, 1996); *Lamp Technologies* (pub. avail. May 29, 1997) ("*Lamp*").
[7] *See id.*

investor has been a client for six months, even if the client relationship began after the offering in question.

"Hedge fund" directories came on to the scene in the early 1990s. What level of participation in the production of these publications caused the information included to be "ascribed" to the funds included in the directories was a matter of ongoing debate. Paying to be included in the directory seemed to be a bad fact, as did cooperating in its publication, but if the funds did not cooperate in the publication, the information included in such directories would almost certainly be wrong and the users of such directories thereby misled with respect to the non-cooperating funds. Hedge fund directories have since flourished (*e.g.*, InfoVest, MAR and HFR), but without real clarity as to their legal status. The Staff was consulted, in person, by representatives of the Klitzberg group — which printed the first such directory — but declined to give definite guidance. In the case of the *Glenwood Investment Company* no-action letter submission on the subject of such directories, the Staff deliberated for a year only to inform the submitters that the Staff would not respond.[8]

The advent of the Internet — which, as the Release makes clear, is a major technological advance in terms of the distribution of financial information — has materially increased the need of the private investment industry for guidance in this area of law. In the wake of the *Lamp Technologies, Inc.* no-action letter,[9] which was itself strictly limited, any number of intermediary — as well as issuer-sponsored — websites have been spawned. Are such websites 502(c) compliant? So far no opinion has been given on this point. The Staff has, on a number of occasions, suggested that it would address these issues, but such guidance has not been forthcoming.

The history of 502(c) suggests that if the legal, administrative and technological resources which has been devoted to attempting to determine the appropriate scope of 502(c) over the last 25 years has not been able to do so, it is likely that the issue itself has no good solution. The line between general and private solicitation may be inherently unclear (in practice, if not in theory). The uncertainty of 502(c) is in harsh contrast to the potentially catastrophic ("draconian" in the words of the Release) consequences of failing to comply.[10] Perhaps in no other area of securities law does breach of a single legal principle have such drastic consequences. A domestic Private Investment Vehicle that violates 502(c) has no alternative but to dissolve — with the sponsor being held responsible for granting rescission to all investors. MFA fully endorses the Release's approach of achieving clarity by defining a group of offerees with respect to which the distinction between general and private solicitation is not relevant.

The SEC Staff proposed in 2003 that the 502(c) limitation be eliminated for offerings made only to "qualified purchasers."[11] The Staff rationale continues to be compelling:

---

[8] *Glenwood Investment Corp.* (pub. avail. Aug. 10, 1994).
[9] *Lamp*, *supra* note 6.
[10] Release at 71.
[11] *Implications of the Growth of Hedge Funds*, Staff Report to the United States Securities Exchange Commission,

> We question whether the restrictions on general solicitation for private placement offerings of interests in funds relying on Section 3(c)(7) of the Investment Company Act should be retained. Unlike a Section 3(c)(1) fund, a Section 3(c)(7) fund can be sold to an unlimited number of investors, so long as they are "qualified purchasers." There seems to be little compelling policy justification for prohibiting general solicitation or general advertising in private placement offerings of Section 3(c)(7) funds that are sold only to qualified purchasers.
>
> The staff would be reluctant to ease or eliminate the prohibition on general solicitation for hedge funds or other funds that use the accredited investor standard as their minimum investor criteria. We believe that such an arrangement could increase the level of risk of investment interest by less wealthy investors. On the other hand, permitting funds, including hedge funds, that limit their investors to a higher standard (e.g., "qualified purchasers") to engage in a general solicitation could facilitate capital formation without raising significant investor protection concerns.[12]

The manner of offering restrictions are intended to ensure that only "suitable offerees" are solicited for private placements.[13] The ability to contact persons whom Congress has deemed presumptively suitable (*i.e.*, "Qualified Purchasers") should not be restricted by the "pre-existing substantive relationship" concept. 502(c) has always been but a means to the end of limiting solicitation to suitable offerees; limiting offerees to be "Qualified Purchasers" assures this result.

The SEC itself has commented that it "had never required that a pre-existing relationship exist in all cases in order to comply with 502(c)." This statement is consistent with an approach in which "pre-existing substantive relationships" would not be required for solicitation in situations in which the offerees are presumptively suitable. Whereas what constitutes a "public" rather than a "private solicitation" is inevitably and inherently unclear, it is clear that Qualified Purchasers do not need the protections of 502(c).

In addition to clarifying what are acceptable private placement practices, another regulatory advantage that would be gained by eliminating "Qualified Purchaser-only" offerings from the restrictions of 502(c) would be to clearly distinguish these offerings from those made to other investors. This has been a distinction which the Staff appears to have been anxious to make. For example, when Section 3(c)(7) of the Company Act was under debate in Congress, a proposal was made not to make separate 3(c)(7) funds, but rather simply not to count "Qualified Purchasers" in a 3(c)(1) fund toward the 100 person statutory limit. The Staff rejected this proposal because it was concerned that "Qualified Purchasers" should not be commingled with other investors, as the former would receive preferential treatment in the event that a fund had

---

September 2003 (the "Hedge Fund Report").

[12] *Id. at* 100-101.

[13] *See, e.g.,* SEC Release No. 33-285 (Jan. 24, 1935).

difficulties. By relaxing 502(c) with respect to offerings to "Qualified Purchasers" only, the Staff would draw a clear distinction between Private Investment Vehicle offerings to Qualified Purchasers and offerings to less suitable investors.

II. Section 404 of the Sarbanes-Oxley Act and Public Commodity Pools

Recommendation III.P.1 recommends a relaxation of the Section 404 compliance requirements imposed by the Sarbanes-Oxley Act of 2002.

MFA heartily supports the proposal in the Release to exempt small public companies from certain of the requirements of Section 404[14] of the Sarbanes-Oxley Act of 2002 ("Section 404"), and recommends that Section 404 relief should be extended to those "public companies" which have no operations, but are only '"net asset value"-based trading entities (*i.e.*, public commodity pools ("Pools")). Registered investment companies are specifically exempted from Section 404, irrespective of size; and Pools should also be exempted.

Pools are subject to the reporting requirements of the 1934 Act. In addition, they are subject to an entirely separate body of regulation under the Commodity Exchange Act. The Pools are further subject to substantive regulation by the states under Blue Sky laws.

Most importantly for purposes of Section 404, however, there are few internal controls that are required or can be required of Pools. Their operations are fully summarized in daily brokerage statements; they trade highly liquid assets in a world of daily settlements. Internal controls are, of course, crucial regulatory compliance tools to the extent they are properly applied to an issuer. However, to require outside auditors to review the internal controls of a Pool would serve no purpose. Absent outright fraud — which outside review would be unlikely to detect or prevent — there is virtually nothing that needs to be "controlled" in a Pool's accounting cycle.

The Release bases its argument for exempting smaller public companies from full Section 404 compliance on a cost benefit analysis. The argument for exempting Pools from Section 404 goes beyond just cost benefit analysis (although such analysis is clearly relevant) to the substantive nature of the Pools' operations. Given the simplicity of the Pools' operations — which, for the most part, maintain all of their capital on deposit with entities which are themselves heavily regulated (*e.g.*, broker-dealers and futures commission merchants ("FCMs")) — there is no meaningful investor protection benefit to be gained from insisting on the full Section 404 procedures with respect to Pools. Pools are regulated by the SEC, the CFTC and the states; they are required to provide monthly net asset values and informally providing net asset values; they issue securities which do not trade and which, accordingly, cannot be the subject of manipulation; and they hold substantially all of their assets in cash or cash equivalents in order to support their trading activities. Pools are not operations to which external audit review or internal controls would add any value. Pools are effectively prohibited from engaging in any significant operations other than trading futures and forward contracts, as doing so would either result in Pools becoming unregistered investment companies or would have potentially materially adverse consequences to investors under the "publicly-traded partnership" rules.

[14] 15 U.S.C. § 7262.

Furthermore, the Pools' net asset value structure makes the burden of compliance more onerous than in the case of smaller public companies.[15] If an operating company were to pay $1 million to achieve Section 404 compliance, it is unclear how that expenditure will affect the value of such company's stock.[16] In the case of the Pools, that $1 million expenditure directly impacts the bottom line, reducing the net asset value of investors' holdings dollar for dollar.[17]

MFA also wishes to point out that the Pools are subject to regulatory audits by the National Futures Association (the "NFA"), audits which generally occur every 3 years and provide oversight of the Pools' accounting processes — an oversight that is not applicable to most "smaller public companies."

The Release's rationale of mitigating the application of Section 404 to smaller public companies applies to an even greater extent to the Pools.

III. Ownership Within the Meaning of Section 12(g) of the 1934 Act

Recommendation IV.S.1 proposes a radical change in the definition of "held of record" under Sections 12(g) and 15(d) of the 1934 Act so as to encompass beneficial holders.

This seemingly incidental proposal included in the Release needs urgent attention. Changing the definition of "owner of record" for the purpose of Section 12(g) of the 1934 Act from legal to beneficial ownership would have enormously disruptive and harmful effects on Private Investment Vehicles.

"Held of record" has historically been interpreted very narrowly: only the legal titleholder has been counted as a holder of record. Importantly, a very large number of Private Investment Vehicles have expressly relied on years of SEC precedent to this effect in developing their business plans. Many of these companies do not, and can not, generate GAAP financials, and, accordingly, could not become reporting companies. Suddenly to reverse the consistently narrow interpretation of "held of record," which the SEC has taken since inception, would drive many of these companies out of business.

Of particular concern to MFA is the number of large Private Investment Vehicles that have relied on the SEC's narrow interpretation of ownership under Section 12(g) in structuring their investor bases so as not to be required to register under the 1934 Act. Were the current Section 12(g) definition to be changed, there would be a significant number of funds which would be required to register under the 1934 Act. However, they could not do so, as they could not comply with the timeliness requirements for the filing of 1934 Act periodic reports (the SEC itself has recognized this issue in a different context, extending the time for the delivery of audits by Private Investment Vehicle "funds of funds" under Rule 206(4)-2 of the Investment Advisers

---

[15] *See* Letter from Brad Smith to Committee (May 24, 2005).
[16] *See* CRA International Sarbanes-Oxley Section 404 Costs and Implementation Issues: Survey Update, at 1.
[17] Section 2(b) of the Securities Act of 1933 mandates that whenever the SEC engages in rulemaking, it is required to consider whether the action will promote efficiency, competition and capital formation. *See* Peter J. Wallison, *Buried Treasure: A Court Rediscovers A Congressional Mandate the SEC Has Ignored*, AEI Online (Oct. 2005).

Act of 1940 to 180 days).[18] There are other materially adverse consequences which would result were Private Investment Vehicles required to become 1934 Act filers — for example, they would be required publicly to disclose highly confidential and proprietary information — but these are afterthoughts to the overriding fact that a requirement of registration would be a death sentence to the many Private Investment Vehicles which would be required to liquidate in many cases.

A crucial point here is that there is no need for Private Investment Vehicles to be subject to a regulatory regime directed at issuers whose securities are publicly traded. Clearly, difficulty of compliance would not alone justify exemption, were there a valid investor protection rationale for insisting upon compliance. There is no such rationale. The securities of Private Investment Vehicles do not trade publicly. Private Investment Vehicles are net asset value entities, without any trading market and without any need for information concerning their operations. Furthermore, Pools transmit directly to each investor current information concerning the net asset value of their investments as well as the performance of the Private Investment Vehicle over time. All investors who have any need for such information receive such information directly from the Private Investment Vehicles themselves; they have no need for these Vehicles to be subject to 1934 Act reporting in order to protect themselves.

We have no comment on whether or not expanding the Section 12(g) definition of owners to include "beneficial" owners is appropriate in the context of publicly-traded operating companies. However, a clear line can be drawn between such companies and Private Investment Vehicles in which investors redeem their interests directly from the Vehicle rather than trading their interests publicly.

In summary, to expand the financial reporting regime designed for publicly-traded companies to include Private Investment Vehicles makes little regulatory sense; to do so at this time — in direct contradiction of years of precedent establishing a restrictive interpretation of the scope of "held of record" — would result in any number of prominent Private Investment Vehicles being forced to liquidate, to the material detriment not only of their sponsors but also of the foundations, pension plans and other institutional investors that are their primary investor base.

[*Continued on the next page*.]

---

[18] Revisions to Accelerated Filer Definition and Accelerated Deadlines for Filing Periodic Reports, SEC Release No. 33-8617 (Sept. 22, 2005).

MFA again thanks the Staff for the opportunity to comment on the Release. For further comments or discussion, please contact me at 202.367.1140.

Sincerely yours,

/s/ John G. Gaine

John G. Gaine
President

CC: Christopher Cox, Chairman
Cynthia A. Glassman, Commissioner
Paul S. Atkins, Commissioner
Roel C. Campos, Commissioner
Annette L. Nazareth, Commissioner