MANAGED FUNDS ASSOCIATION

October 19, 2007

VIA ELECTRONIC MAIL:
rule-comments@sec.gov

Attention: Nancy M. Morris, Secretary
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549

Re: Revisions of Limited Offering Exemptions in Regulation D; File No. S7-18-07

Ladies and Gentlemen:

Managed Funds Association ("MFA") appreciates the opportunity to comment on the U.S. Securities and Exchange Commission's ("SEC" or the "Commission") proposed rule to revise the limited offering exemptions in Regulation D, Release No. 33-8828 (Aug. 10, 2007), 72 Fed. Reg. 45116 (the "Release").

MFA is the voice of the global alternative investment industry. Our members include professionals in hedge funds, funds of funds and managed futures funds. Established in 1991, MFA is the primary source of information for policymakers and the media and the leading advocate for sound business practices and industry growth. MFA members represent the vast majority of the largest hedge fund groups in the world who manage a substantial portion of the over $1.67 trillion invested in absolute return strategies. MFA is headquartered in Washington, D.C., with an office in New York.

MFA Comments and Recommendations on the Proposals in the Release

We support the Commission's efforts to revise Regulation D to provide additional flexibility to issuers and to clarify and improve the application of the rules. A number of modifications are necessary, however, to ensure that the proposals appropriately achieve the Commission's goals. We respectfully submit our comments and recommendations below.

A. Large Accredited Investor and Accredited Natural Person Proposals

In the Release, the Commission proposes to create another new category of investor, the "Large Accredited Investor," and provide an exemption from the registration provisions of the Securities Act of 1933 ("1933 Act") for offers and sales of securities to these individuals ("Proposed Rule 507"). As set forth in Proposed Rule 507, this exemption would also permit an issuer to publish a limited announcement of the offering. Pooled investment vehicles relying on Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act of 1940 ("1940 Act") ("3(c)(1) Funds" and "3(c)(7) Funds" respectively) are specifically excluded from taking advantage of this exemption because such funds are required to sell their securities in transactions that are not public offerings and rely typically on Section 4(2) of the 1933 Act and Rule 506 of Regulation D,

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which expressly forbids general solicitation and general advertising. The framework for the proposed definition of this new class of investor is based on the existing "accredited investor" definition, but the proposal has higher dollar-amount thresholds for qualification due to what the Commission perceives to be increased risk to investors for Proposed Rule 507 offerings.

The Commission is also seeking further comment on the other new accredited investor category proposed in December 2006 ("Accredited Natural Person Proposal").[1] This proposal applies solely to investments by individuals in certain 3(c)(1) Funds which rely on Rule 506 to raise capital, and adds an ownership requirement of $2.5 million in investments for these investors.[2] We maintain the position articulated in our comment letter submitted on March 9, 2007 in connection with the Private Pooled Investment Vehicle Release ("March 9th Letter") that the creation of new accredited investor categories and financial sophistication standards is unnecessary to achieve the Commission's goal of investor protection.[3] As discussed in the March 9th letter, there already are six financial sophistication standards under federal regulations, each of which largely serve the same purpose.[4] The creation of two new standards, i.e., Accredited Natural Person and Large Accredited Investor, could further confuse investors and unnecessarily increase the administrative costs they pay. Therefore, MFA opposes the adoption of the two proposed new standards.

We believe the Commission can accomplish its goal simply and more directly by (1) not adopting the Accredited Natural Person Proposal and Proposed Rule 507 and (2) taking a tiered approach to the accredited investor standard based on the type of offering, with the thresholds in the proposed definition of accredited investor ("Accredited Investor Proposal") used as a baseline. We agree with the Commission that it is time to reconsider whether the current financial standard for natural persons is an appropriate threshold for investing in private pools of capital.[5] Although we believe that the existing accredited investor rule has been successful in limiting private pools of capital and other more risky investments to sophisticated investors, we recognize that "inflation, along with the sustained growth in wealth and income of the 1990s, has

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[1] Securities Release No. 8766 (Jan. 4, 2006), 72 Fed. Reg. 400 (hereinafter "Private Pooled Investment Vehicle Release").

[2] *Id.* at 405. The Accredited Natural Person Proposal would not apply to offers and sales of securities issued by private funds not meeting the proposed definition of the term "private investment vehicle," including venture capital funds. The Private Pooled Investment Vehicle Release defines "private investment vehicle" as any issuer that would be an investment company as defined in Section 3(a) of the 1940 Act but for the exclusion provided for in Section 3(c)(1) of the 1940 Act.

[3] Letter from John Gaine, MFA President, to Nancy M. Morris, SEC (Mar. 9, 2007) (available at http://www.sec.gov/comments/s7-25-06/s72506-567.pdf).

[4] *Id.* at 4. Financial sophistication standards under current federal regulations include: Accredited Investor, qualified client, qualified purchaser, qualified institutional buyer, qualified eligible person and eligible contract participant. *See* Attachment 1 of March 9th Letter, Chart Summarizing Sophisticated Investor Standards.

[5] We note that managed futures funds rely on the Regulation D exemption to raise capital and are subject to extensive regulation by the Commodity Futures Trading Commission and the National Futures Association in addition to being regulated by the Commission.

boosted a substantial number of investors past the 'accredited investor' standard."[6] The financial eligibility standard for natural persons in the existing definition of accredited investor has not changed since it was first adopted in 1982. Therefore, we recommend that the Commission amend the proposed accredited investor definition solely for offers and sales of securities issued by 3(c)(1) Funds,[7] by adjusting for inflation the $1 million net worth, $200,000 individual income, and $300,000 joint income thresholds immediately.[8] The Commission's Office of Economic Analysis estimated that these numbers, adjusted for inflation, would have been approximately $1.9 million (net worth), $388,000 (individual income), and $582,000 (joint income) as of July 1, 2006.[9] We do not believe that future inflation adjustments should be automatic, but rather should be implemented on an as needed basis. We have long advocated increasing the financial eligibility standards for investors in 3(c)(1) Funds.[10] We believe this increase will address the Commission's concerns regarding investor participation in these funds, while aligning the thresholds with the effects of inflation.

With respect to Proposed Rule 507, we urge the Commission to undertake a comprehensive reevaluation of Rule 502(c) of Regulation D, which prohibits general solicitation and advertising, rather than continuing the prohibition and carving out limited announcements in connection with Proposed Rule 507 offerings. We believe that permitting limited announcements does not address the uncertainties and interpretive issues surrounding what constitutes general solicitation. These issues are impediments to capital formation and result in increased compliance and legal costs for issuers. Therefore, we request that the Commission also provide clarification regarding the scope of permissible activities when dealing with potential investors. In addition, the Commission should consider the necessity of this absolute prohibition with respect to Rule 506 offerings to "accredited investors." These investors can "fend for themselves" and do not need any additional protection the prohibition may provide. We are concerned that this prohibition prevents issuers, particularly hedge funds, from providing greater transparency to their prospective investors and does not promote the Commission's goal of investor protection. In its September 2003 report entitled "Implications of the Growth of Hedge Funds," the Staff urged the Commission to consider permitting general solicitation in 3(c)(7) offerings noting that "there seems to be little compelling policy justification for prohibiting general solicitation or general advertising in private placement offerings of 3(c)(7) Funds that are sold only to qualified purchasers."[11] We agree with the Staff's assessment that "permitting funds,

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[6] *Implications of the Growth of Hedge Funds, Staff Report to the United States Securities and Exchange Commission* (Sept. 2003) at text accompanying note 271 (available at http://www.sec.gov/spotlight/hedgefunds.htm) (hereinafter "2003 Report").

[7] Because 3(c)(7) Funds may sell their securities only to "qualified purchasers", a more restrictive definition than accredited investor, it would not appear to be necessary to increase the accredited investor financial sophistication standard for such issuers.

[8] We do not believe it is appropriate to adjust the proposed investments threshold for inflation as it is not apart of the existing accredited investor eligibility standard.

[9] Private Pooled Investment Vehicle Release, 72 Fed. Reg. 400, 406.

[10] *White Paper on Increasing Financial Eligibility Standards for Investors in Hedge Funds,* Managed Funds Association, July 7, 2003, *available at:* http://www.mfainfo.org/images/PDF/WhitePaperInvestorEligibilityFinal.pdf.

[11] 2003 Report, supra note 6, at 100.

including hedge funds to engage in a general solicitation could facilitate capital formation without raising significant investor protection concerns."[12]

Although the Staff stated in its 2003 Report that it 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[13] (i.e., 3(c)(1) Funds), we believe the Commission should reconsider this position because the thresholds contemplated by an inflation-adjusted accredited investor standard for 3(c)(1) Funds are significantly higher than the Accredited Investor Proposal. The higher thresholds address the Commission's perception of increased risks to investors relating to general solicitation and advertising. We believe that higher thresholds provide the assurance that the investors in the offerings can "fend for themselves."

B. Accredited Investor Proposal

1. The Definition and Treatment of Joint Investments Should Be Consistent with the Treatment of Such Investments for the Purposes of the Qualified Purchaser Definition Under the 1940 Act and the Qualified Client Definition of the Advisers Act.

The Commission proposes to revise the current definition of accredited investor by adding an alternative "investments-owned" standard. We support this proposal and believe that the standard would reduce and simplify compliance burdens for issuers by providing an alternative standard that may be applied more easily than the current net worth or annual income standards. We are concerned however, that investor confusion would result from the definition and treatment of joint investments under the alternative investments-owned standard, which is inconsistent with existing federal regulations.

The Release states that an individual seeking to make an investment in a Regulation D offering without obtaining the signature and binding commitment of his or her spouse may include only 50 percent of any investments held jointly with the individual's spouse or as community property. For simplification and consistency purposes, we believe that the full amount of joint investments should be included in any calculation for determining an investor's accreditation. As written, the proposal would cause differential treatment of marital assets when qualifying as an accredited investor on the basis of net worth versus investments. We believe the treatment should be the same regardless of the standard used.

Moreover, it could be confusing for investors and managers to have the term "joint investments" defined differently under the standards in the Accredited Investor Proposal and the other financial sophistication standards, such as, qualified client[14] and qualified purchaser[15]. For example, when a prospective investor is completing a subscription agreement for a pooled

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[12] *Id.* at 101.

[13] *Id.*

[14] Rule 205-3(d)(1)(ii)(A) of the Investment Advisers Act of 1940 ("Advisers Act").

[15] Rule 2a51-1(g)(2) of the 1940 Act.

investment fund, he or she may be confused by the differential treatment of joint investments in the qualifying standards for qualified purchasers and accredited investors. We believe the terms or definitions used in the federal financial sophistication standards[16] should be as uniform and logically consistent as possible to prevent investor confusion as well as to enhance investor and manager compliance. The process of incorporating the various financial eligibility standards into a subscription agreement is already a challenging one, and can potentially lead to inadvertent violations of the federal securities laws. We are concerned that cumbersome, complicated and disparate standards for qualifying "sophisticated investors" are unreasonable barriers to entry that would have a chilling effect on competition and inhibit investment in offerings in the United States. Complex and inconsistent regulation also may result in offerors seeking to move their businesses outside of the United States. Therefore, we believe the definition and treatment of joint investments should be consistent with the treatment of such investments for the purposes of the qualified purchaser definition under Rule 2a51-1(g)(2) of the 1940 Act and the qualified client definition under Rule 205-3(d)(1)(ii)(A) of the Advisers Act.

2. *The Proposed Future Inflation Adjustment Will Create an Anomaly for Investments in 3(c)(1) and 3(c)(7) Funds.*

The Commission proposes to begin inflation-indexing the dollar-amount thresholds required for qualification as an accredited investor every five years starting in 2012. We are concerned that the Commission's proposal will result in an anomaly where, the inflation adjustment provision would eventually make it more difficult for a natural person to invest in a 3(c)(1) Fund than a 3(c)(7) Fund. Regulation D imposes a $1 million net worth financial standard for natural persons investing in a private placement. The 1940 Act imposes no financial standard for natural persons investing in a 3(c)(1) Fund and a $5 million "investments" financial standard for natural persons investing in a 3(c)(7) Fund. A typical 3(c)(1) Fund requires investor accreditation to comply with Regulation D. As a result, under the Accredited Investor Proposal, the net worth standard for a natural person to invest in a 3(c)(1) Fund could someday exceed the $5 million "investments" standard for a natural person to invest in a 3(c)(7) Fund. We do not believe that this is an appropriate outcome or sound public policy as it seems contrary to the original intent of the 1940 Act.

We recommend that the Commission not require automatic inflation adjustments every five years after 2012, but rather evaluate the thresholds every five years to determine whether an adjustment is necessary. In addition, we suggest that the Commission cap the net worth threshold at $4.99 million. We believe that this approach will better enhance investor protection.

3. *The Definition of Accredited Investor Should Include Qualified Purchasers, Knowledgeable Employees, Trust Grantors, Trustees, and Beneficiaries.*

The Commission proposes to add certain categories of legal entities to the list of permitted accredited investors in Rule 501(a)(3). Although we fully support this proposal, we believe that the definition of accredited investor should also be amended to include qualified purchasers, knowledgeable employees, trust grantors, trustees, and beneficiaries.

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[16] *See* Attachment 1 of March 9th Letter, Chart Summarizing Sophisticated Investor Standards, *supra* note 3.

a) Qualified Purchasers

We recommend that the Commission consider adding qualified purchasers as defined by the 1940 Act to the list of accredited investors. Section 2(a)(51)(A) of the 1940 Act defines a "qualified purchaser" to include natural persons and institutions who have at least $5 million and $25 million in investments, respectively.[17] The thresholds in this standard already far exceed the investment requirements of the Accredited Investor and Large Accredited Investor Proposals. Moreover, qualified purchasers have a high degree of financial sophistication and the ability to withstand a greater degree of risk. We believe that amending the accredited investor definition to include this class of investor would reduce transaction costs greatly by simplifying certain agreements (*e.g.* eliminating duplicative investor representations in 3(c)(7) Fund subscription agreements), improve economic efficiency, and increase investor protection.

b) Knowledgeable Employees

In our March 9th Letter, we recommended the Commission broaden the scope of the definition of "Knowledgeable Employee" under Rule 3c-5 of the 1940 Act to include employees involved in the operation of a 3(c)(1) or 3(c)(7) Fund or its investment process (other than an employee performing solely clerical, secretarial or administrative functions), such as, marketing and investor relations professionals; research analysts; attorneys; traders; brokers and traders of a fund affiliate; and senior financial, compliance, operational and accounting officers. We believe that these employees become quite familiar with the risk/return and other characteristics of investments managed by their employers from many vantage points and possess a sophisticated and knowledgeable understanding of the investment objectives, risks and operations of their employer's funds. Therefore, we urged the Commission, in the interest of protecting investors, to allow employees that meet the revised definition of Knowledgeable Employee to invest in the 3(c)(1) and 3(c)(7) Funds managed by their employer both directly and through deferred compensation and other similar arrangements.[18]

We reassert this position and urge the Commission to consider amending the definition of accredited investor to include "knowledgeable employees." These employees should not be required to meet the net worth, income and investments tests due to their positions with the issuer and their sophistication with respect to the investment. We believe that one of the best ways to protect investors is to have fund principals' and the manager's employees' interests aligned with the interests of investors, through their own investments in the fund. Further, permitting a broader category of "knowledgeable employee" to invest in the manager's funds would represent a simple, yet highly meaningful, policy change which would significantly enhance investor protection. Just as a person would find it imprudent to invest in a start-up company where the company's founders and key players did not have a financial interest and/or personal investment at risk, 3(c)(1) and 3(c)(7) Fund investors would find more security in investing in a fund where the manager's employees have aligned interests in the fund's performance. From our experience, prospective investors are keen to learn that the employees of a pooled investment fund's manager are invested in their employer's funds. Further, investors have a strong interest in a fund's ability to attract and retain talented fund employees. Allowing a manager's employees to invest in pooled investment funds managed by their employer is an important retention tool and employee benefit that can help a fund attract and retain talented employees, such as the best risk and

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[17] 15 U.S.C. §80a-2(a)(51)(A).

[18] See March 9th Letter, *supra* note 3 at 6-7.

portfolio managers. Such an employee benefit would be akin to a start-up company's ability to offer employees stock or investment opportunities to help attract and retain talented employees who, in turn, help spawn innovation and development.

We recommend that the Commission consider amending the Rule 501 definition of accredited investor, specifically Rule 501(a)(4), to include certain knowledgeable employees of the manager to the pooled investment funds. While such individuals would not necessarily meet higher net worth and income standards, their position inside the fund or its manager provides them with financial sophistication, knowledge and experience in financial matters.

c) Trust Grantors, Trustees and Beneficiaries

We also believe that the Commission should modify Rule 501(a)(7) to include any trust where a grantor, trustee or each primary beneficiary is an accredited investor. Currently, Rule 501(a)(7) provides accredited investor status to

> [a]ny trust, with total assets in excess of $5,000,000, not formed for the specific purpose of acquiring the securities offered, whose purchase is directed by a sophisticated person as described in Rule 506(b)(2)(ii).

The modification seeks to make the Rule consistent with Rule 501(a)(8) which defines as an accredited investor an entity in which all of the equity owners are accredited investors. Grantors, trustees and beneficiaries are considered owners of the trust via look-through treatment. We believe that this modification would further the Commission's goal of consistency across the federal securities laws. In particular, we believe that it is important to refer to primary beneficiaries of the trust, beneficiaries who would receive trust assets if the trust's assets were distributed today. We think it would be unfair to have to qualify contingent beneficiaries who may or may not be known and who may or may not receive distributions from the trust.

We recommend that the Commission replace the language in Rule 501(a)(7) with the following:

> "7. Any trust of which a grantor (at the time of the trust's establishment), a trustee, or each primary beneficiary is an accredited investor, or any trust with total assets in excess of $5,000,000, not formed for the specific purpose of acquiring the securities offered, whose purchase is directed by a sophisticated person as described in Rule 506(b)(2)(ii)."

4. Current Investors Should be Grandfathered for Future Investments in an Offering.

The Release does not address how current investors in an offering will be affected by future inflation adjustments to the dollar-amount thresholds in the Accredited Investor and Large Accredited Investor Proposals. Without a grandfather provision, current investors may be rendered ineligible to make future investments in an offering because of their inability to meet the inflation-adjusted thresholds. Moreover, these investors may not be permitted to reinvest their earnings in offerings. Investors spend a substantial amount of time and money performing due

diligence on an issuer conducting a Regulation D offering before investing. We believe it would be unfair to investors who have already performed extensive due diligence and committed capital to a issuer to be required to dispose of their interests in a offering or to be restricted from making further investments in the offering.

We note that the Commission has allowed grandfathering in the 3(c)(7) context. When a 3(c)(1) Fund converts into a 3(c)(7) Fund, the Commission allows the grandfathered fund to preserve its arrangements with its non-qualified purchasers and does not limit additional purchases by these purchasers of the grandfathered fund's securities.[19] Therefore, we urge the Commission to include a grandfather provision in the Accredited Investor and Large Accredited Investor Proposals to allow existing investors who would not meet the inflation-adjusted Accredited Investor and Large Accredited Investor standards to retain their investments and continue investing in the same offering in which they were invested prior to the rule change.

C. Integration Safe Harbor

The Commission proposes to shorten the length of time required by the integration safe harbor for Regulation D offerings from 6 months to 90 days. We support the proposal as it would provide issuers with greater flexibility to conduct more frequent offerings to meet unpredictable financing needs, and would provide investors greater transparency. Greater flexibility would also allow issuers to better time their offerings to potentially lower their costs of capital.

D. Limitations on the Manner of Offering

The Commission is soliciting comments on whether the current Rule 508 carve-out for manner of sale limitations from the list of insignificant deviations should be deleted. Rule 508 provides that insignificant deviations from the requirements of Regulation D do not result in the loss of the exemption. Rule 508(a)(2) provides, however, that failures with regard to the limitations on the manner of offering are deemed significant. As a result, an issuer's failure to comply with the prohibition on general solicitation applicable to a Regulation D offering is automatically considered a significant deviation. We are concerned that the Rule 508 defense can never be applied to insignificant deviations relating to general solicitation. For example, there are instances where, without general solicitation, the press may become aware of an offering and contact the issuer for more information about the offering. If the issuer responds to the questions, it may be considered a significant deviation relating to general solicitation or general advertising. We recommend that the Commission remove the manner of sale limitation and permit issuers to raise the Rule 508 defense with respect to persons who were not generally solicited in an offering that was structured to avoid general solicitation.

E. Disqualification Provisions

The Commission proposes to apply disqualification provisions to all Regulation D offerings. Under the proposed rule, a Regulation D exemption would not be available to an issuer if it or an affiliated person (any predecessor, affiliated issuer, director, executive officer, general partner, managing member, 20% beneficial owner or promoter) has violated a relevant law or regulation. We are concerned that the disqualifying provisions are overly broad and imprecise. For example, cease and desist orders (referenced in proposed rule 502(e)(1)(v)) can be entered for technical violations that have nothing to do with fraud (*e.g.,* failure to file Form D or failure to

[19] 68 Fed. Reg. 17520 n.82.

make a timely blue sky filing), and result in an issuer being precluded from making a Regulation D exempt offering for five years.

We urge the Commission to reconsider conditioning the availability of all Regulation D exemptions on the application of bad actor disqualification provisions. We believe that the disqualification provisions should be limited to Rule 505 only and the extension of these provisions to all Regulation D offerings is unnecessary. In the Release, the Commission states that the need for bad actor disqualification provisions arises from the number of recidivists in problematic Regulation D offerings.[20] The Commission has not provided any justification (empirical evidence or otherwise) for this assertion. We believe that any concerns regarding "bad actors" and "recidivism" are best handled by the Division of Enforcement. Moreover, the list of persons and entities subject to the disqualification provisions is overly broad. For example, the Release states that "limiting the scope of these provisions to … 20 percent beneficial owners would be appropriate, given their greater influence on the policies of the issuer as compared to … 10 percent beneficial owners."[21] Since pooled investment funds generally engage in continuous offerings, investors deemed 20% beneficial owners change constantly. Moreover, it is not unusual to have 20% beneficial owners who are investors with limited or no voting rights and no practical way to exert control. These passive investors would have no influence on the policies of the issuer, and such investors may be unwilling to share their "bad boy events" with the fund issuer. We also are concerned that the Commission's proposal will encourage bad actors or serious securities law violators to rely on Section 4(2) in which there is no notice filing. As a result, the Commission would be unaware of such offerings and unable to capture the serious securities law violators that it seeks.

In addition, we note that when Congress adopted Section 18 of the 1933 Act as a part of the National Securities Markets Improvement Act of 1996, it had the ability to preserve the states' rights to adopt bad actor provisions and did not do so. Congress also expressly stated that the states could only condition Rule 506 offerings on federal requirements.[22] We believe that it is inappropriate for the Commission to propose the adoption of disqualification provisions by rule when Congress chose not to include such provisions in the 1933 Act for Rule 506 offerings.

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[20] *Id.*

[21] *Id.* at n.147.

[22] 15 U.S.C. §77a-18(a)(2).

Conclusion

MFA appreciates the opportunity to comment on the Commission's proposed rule seeking to revise the limited offering exemptions in Regulation D. We support the Commission's efforts toward protecting investors and creating a better investment environment. We are not opposed to any and all regulation. We want to ensure, however, that any regulation promulgated by the Commission is both effective and the least intrusive and burdensome means of accomplishing the Commission's goals. We would be pleased to meet with the Commission or Staff to discuss our comments.

Respectfully submitted,

John G. Gaine
President

cc: The Hon. Christopher Cox, Chairman
The Hon. Paul S. Atkins Commissioner
The Hon. Annette L. Nazareth
The Hon. Kathleen L. Casey
John White, Director
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