MANAGED FUNDS ASSOCIATION
The Voice of the Global Alternative Investment Industry
WASHINGTON, DC | NEW YORK

November 14, 2011

VIA EMAIL

Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: FINRA Rule 5123 (Private Placements of Securities); File Number S7-FINRA-2011-057

Dear Ms. Murphy:

Managed Funds Association ("MFA")[1] appreciates the opportunity to provide comments to the Securities and Exchange Commission's (the "SEC") notice of the Financial Industry Regulatory Authority's ("FINRA") proposed new Rule 5123.[2] Rule 5123 would require FINRA members that offer or sell certain private placements, or participate in the preparation of disclosure documents in connection with such private placements, to provide disclosures to each investor prior to sale describing the anticipated use of offering proceeds, and the amount and type of offering expenses and offering compensation. The Rule would also require a FINRA member to file the disclosure document with FINRA no later than 15 days after the first sale. The Rule is designed to provide both investors and FINRA with information about private placements.

The Rule Should Exempt Private Offerings to Sophisticated Investors

Rule 5123 would exempt from its requirements certain types of private offerings, as well as private offerings sold to specific types of purchasers. The proposal does not explain the policy basis for each such exemption, but rather notes that FINRA believes the exemptions are appropriately tailored and inclusive, and are similar to those in existing Rule 5122. Based on the list of exemptions, it appears that they are designed in part to apply to certain private offerings made to sophisticated investors.

[1] MFA is the voice of the global alternative investment industry. Its members are professionals in hedge funds, funds of funds and managed futures funds, as well as industry service providers. Established in 1991, MFA is the primary source of information for policy makers and the media and the leading advocate for sound business practices and industry growth. MFA members include the vast majority of the largest hedge fund groups in the world who manage a substantial portion of the approximately $1.9 trillion invested in absolute return strategies. MFA is headquartered in Washington, D.C., with an office in New York.

[2] Notice of Filing of Proposed Rule Change to Adopt New FINRA Rule 5123 (Private Placements of Securities), Securities Exchange Act Release No. 65585 (Oct. 18, 2011); 76 F.R. 65758 (Oct. 24, 2011). The proposal follows FINRA's proposed amendments to Rule 5122. *See* Private Placements of Securities, FINRA Regulatory Notice 11-04 (Jan. 2011), available at: http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p122787.pdf.

We agree that offerings made to sophisticated investors should be exempt from the proposed disclosure requirements. The sophistication standards in the federal securities laws are designed to ensure that investors with the financial wherewithal to understand and evaluate investments are able to purchase interests in private offerings. These sophisticated investors typically perform extensive due diligence prior to investing, and obtain detailed information about an offering when making their investment decision.

The federal securities laws generally require private funds to offer their securities only to sophisticated investors. Funds that rely on Section 3(c)(7) of the Investment Company Act of 1940 (the "Investment Company Act") generally must have only "qualified purchasers," as defined in Section 2(a)(51) of the Act, as owners of their securities. Private funds that rely on Section 3(c)(1) of the Investment Company Act and are managed by a registered investment adviser generally must have only "qualified clients," as defined in Rule 205-3 under the Investment Advisers Act of 1940 (the "Investment Advisers Act"), as beneficial owners of their securities.[3] In addition to these investor thresholds, hedge funds generally comply with the requirements of the Securities Act of 1933 (the "Securities Act") by offering and selling interests only to "accredited investors," as defined in Rule 501 of Regulation D under the Act.

As proposed, Rule 5123 would exempt private offerings purchased by, among others, "qualified purchasers." While this exemption appears to be designed to apply to Section 3(c)(7) funds, we are concerned that in certain circumstances a private offering made by such a fund would not fall within the exemption. For example, persons that are not "qualified purchasers" but are "knowledgeable employees," as defined in Rule 3c-5 under the Investment Company Act, are permitted to purchase interests in a Section 3(c)(7) fund. While Rule 5123 would exempt private placements that are purchased by employees and affiliates of the issuer, it is not clear whether such an exemption would include all types of "knowledgeable employees" that meet the terms of Rule 3c-5. In addition, the SEC staff takes the position that a non-U.S. person that has purchased an interest in a non-U.S. hedge fund that also conducts a private offering in the U.S. in reliance on Section 3(c)(7) need not be a qualified purchaser.[4] As a result, the proposed exemption for offerings made to qualified purchasers may not apply to certain purchasers of interests in Section 3(c)(7) funds, and would therefore be of limited usefulness.

The proposed Rule does not provide for an exemption for offerings made to purchasers of interests in Section 3(c)(1) funds, including "qualified clients" and "accredited investors." In July, pursuant to Section 418 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), the SEC raised the qualification thresholds for a "qualified client" by increasing the required assets under management from $750,000 to $1 million, and the

[3] Section 3(c)(1) does not include as a condition that a private fund relying on the Section only have "qualified clients" as owners of its securities. However, managers to such funds typically charge a performance fee. Fund managers that are registered investment advisers charge a performance fee by complying with Rule 205-3 under the Investment Advisers Act, which provides an exemption from the general prohibition in Section 205 on an adviser receiving compensation on the basis of a share of capital gains of the funds of a client. Rule 205-3 permits a registered investment adviser to charge a performance fee only to a "qualified client."

[4] Goodwin Proctor & Hoar, SEC No-Action Letter (Feb. 28, 1998).

required net worth from $1.5 million to $2 million.[5] The SEC has also proposed to exclude the value of an individual's primary residence from the net worth calculation, and adjust these amounts to account for inflation every five years.[6] In addition, the Dodd-Frank Act strengthens the accredited investor standard by excluding the value of a primary residence from an investor's net worth, instructing the SEC to increase the net worth threshold above the existing level of $1 million, and permitting the SEC to undertake a broad review of the definition of "accredited investor" for the protection of investors, in the public interest, and in light of the economy.[7] Together, these changes enhance the thresholds for investors eligible to purchase interests in funds that rely on Section 3(c)(1), and help to ensure they are sophisticated and able to understand and evaluate investments in private funds.

In addition, requirements imposed on SEC-registered investment advisers to private funds by the Investment Advisers Act make such additional disclosure unnecessary. The recently revised Part 2 of Form ADV, for example, requires hedge fund managers to provide extensive information about their businesses and the operations of funds they manage. The information on Part 2 of Form ADV is publicly available, and can be easily accessed by potential investors and regulators. The Investment Advisers Act also establishes a framework for an SEC-registered investment adviser to engage an entity to provide solicitation services. Rule 206(4)-3 under the Investment Advisers Act requires that a solicitor furnish to a client a separate written disclosure document describing the terms of the relationship and compensation structure. These requirements applicable to SEC-registered hedge fund managers ensure that investors are provided with material information to be used in making their investment decisions.

FINRA Should Not Impose Disclosure Requirements on Private Offerings

We believe Rule 5123 as proposed would conflict with the federal securities laws by mandating that particular information be disclosed in connection with a private offering. As you know, under Section 4(2) of the Securities Act, a transaction by an issuer that does not involve a public offering is exempt from registration under the Act. As a result, private offerings are not required to be sold by means of a registration statement, and are not subject to the disclosure requirements applicable to public offerings. The private offering exemption in Section 4(2) reflects the intent of Congress to exempt transactions "where there is no practical need for [the bill's] application or where the public benefits are too remote."[8]

The SEC, in interpreting and applying the exemption in Section 4(2), has likewise not imposed substantive disclosure requirements on private offerings. Most significantly, the SEC adopted Regulation D almost thirty years ago to provide a safe harbor for private issuers seeking to comply with Section 4(2). While Regulation D includes certain types of offering restrictions,

[5] Order Approving Adjustment for Inflation of the Dollar Amount Tests in Rule 205-3 under the Investment Advisers Act of 1940, Investment Advisers Act Release No. 3236 (July 12, 2011).

[6] Investment Adviser Performance Compensation, Investment Advisers Act Release No. 3198 (May 10, 2011).

[7] Section 413 of the Dodd-Frank Act.

[8] *See e.g.*, H.R. Rep. No. 85, 73d Cong., 1st Sess. 5, 7 15-16 (1933).

such as a prohibition on offering or selling securities by any form of general solicitation or general advertising, it does not prescribe the type of information that issuers must disclose in connection with a private offering. Instead, Regulation D requires an issuer to provide certain information only to a purchaser that is not an accredited investor.[9]

Furthermore, the National Securities Markets Improvement Act of 1996 ("NSMIA") amended the Investment Company Act to add a new exemption for private funds as Section 3(c)(7). A private fund may rely on Section 3(c)(7) if it, among other things, is "not making and does not at that time propose to make a public offering of such securities."[10] The Commission regards transactions that comply with Rule 506 of Regulation D as non-public offerings for purposes of Section 3(c)(7).[11] As a result, both Congress and the SEC have determined not to require private funds that rely on Section 3(c)(7) to disclose certain types of information to investors.

We believe that proposed Rule 5123 would conflict with this long-standing framework for the regulation of offerings by private funds. By requiring that particular information be disclosed in connection with a private offering, the Rule would be inconsistent with both Section 4(2) of the Securities Act, which exempts private offerings from the registration requirement of the Act, and Regulation D, which provides a safe harbor for issuers to comply with Section 4(2). Hedge funds comply with Section 4(2) of the Securities Act and Regulation D by providing investors with offering documents, memoranda and other materials that include extensive information about the activities of the fund and its investment manager. Hedge funds and their investors have operated effectively under these provisions for many years, and we believe this continues to be the appropriate framework to ensure that sophisticated investors in private offerings have access to the type of information necessary to make their investment decisions.[12]

Accordingly, we believe that the proposal is inconsistent with Section 15A(b)(6), Section 19(b)(1)(C), and Section 3(f) of the Securities Exchange Act of 1934 (the "Exchange Act"). Section 15A(b)(6) of the Exchange Act requires, among other things, that FINRA rules must be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in securities, to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest. Section 19(b)1)(C)(i) requires that the Commission approve a proposed rule change if it is consistent with the requirements of the Exchange Act and the rules thereunder that are applicable to such organization, and subsection (ii) directs the Commission to disapprove a proposed rule change if it

[9] Rule 502(b).

[10] In addition, a fund that relies on Section 3(c)(7) must have only "qualified purchasers" as owners of its securities.

[11] *See* Privately Offered Investment Companies, Investment Company Act Release No. 22597 at n. 5 (Apr. 3, 1997).

[12] In addition, the Dodd-Frank Act sets out a clear framework for SEC oversight of private fund managers by requiring such managers to register with the SEC as investment advisers. MFA has consistently supported these provisions of the Dodd-Frank Act.

does not satisfy such standard. Section 3(f) of the Exchange Act requires the Commission as part of its review of a rule of a self-regulatory organization to consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.

As noted above, Congress has established a regulatory framework for private placements that excludes a mandatory disclosure regime. FINRA's proposal – however modest and well-intentioned –would substitute its judgment for the Congress. FINRA may plausibly argue that additional investor disclosure regarding private placements may be helpful to investors.[13] Congress, however, has enacted and repeatedly reaffirmed a statutory framework for private placements generally and for offerings by private funds specifically that leave matters of disclosure to issuers and the sophisticated investors who are eligible purchasers. FINRA does not seem to agree with that judgment and seeks to institute its own disclosure regime for private placements, including offerings by private funds to sophisticated investors. Accordingly, FINRA is seeking to do what the Commission itself cannot do, *i.e*., establish a disclosure regime for private placements to sophisticated investors. MFA believes that such requirements are inconsistent with the statutory scheme in the Investment Company Act, the Securities Act and the Exchange Act that Congress has enacted.[14]

MFA also believes the proposal is inconsistent with Section 3(f) of the Exchange Act, because it is inconsistent with the framework that Congress established for raising capital in private placements. By requiring a FINRA member that offers or sells private placements to provide disclosures to each investor prior to sale, the proposed Rule would make private offerings more costly and less efficient, thereby imposing an unnecessary burden on capital formation. A private fund engaged in an offering would need to prepare the disclosure, and then coordinate with each FINRA member involved with the offering to arrange for delivery of the information, leading to a potentially lengthy review process, difficulties in ensuring that appropriate disclosures were made, and liability concerns. These burdens and delays associated with the disclosure and review process would inhibit private funds from conducting offerings efficiently and obtaining needed capital to invest throughout the economy.[15]

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[13] *See* discussion at 76 F.R. 65760.

[14] The U.S. Supreme Court determined many years ago that the Securities Act and the Exchange Act should be read *in pari materia.* Tcherepnin v. Knight, 389 U.S. 332 (1976). Accordingly, it is improper to read the Exchange Act's grants of authority under Section 15A to a registered securities association in isolation from the entire statutory framework, including the Securities Act's private placement provisions and the remainder of the Exchange Act.

[15] The requirement that the information be disclosed in a private placement memorandum or term sheet, as opposed to a separate disclosure document, would be particularly disruptive and harmful to capital formation. For example, managers may provide an investor with a term sheet or other document prior to a private placement memorandum, and the Rule would create unnecessary confusion in these situations regarding how and when the required information should be disclosed to the investor and filed with FINRA. In addition, under the Rule as proposed, a FINRA member would need to file any material amendments to the documents with FINRA. It is not clear what policy objective would be served by filing amendments to a term sheet or private placement memorandum with FINRA, particularly where such amendments are unrelated to the specific disclosures that would be required by the Rule.

For these reasons, we recommend that FINRA modify proposed Rule 5123 to include exemptions for an offering made by a private fund, as defined in the Investment Advisers Act.[16]

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MFA appreciates the opportunity to provide comments to the Commission in response to FINRA's proposed Rule 5123. If you have any questions about these comments, or if we can provide further information, please do not hesitate to contact Matthew Newell, Assistant General Counsel, or the undersigned at (202) 730-2600.

Respectfully submitted,

/s/ Stuart J. Kaswell

Stuart J. Kaswell
Executive Vice President & Managing Director,
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Cc: Marc Menchel, Executive Vice President and General Counsel for Regulation, FINRA

[16] The term ''private fund'' means an issuer that would be an investment company, as defined in section 3 of the Investment Company Act, but for section 3(c)(1) or 3(c)(7) of that Act. Investment Advisers Act Section 202(a)(29).