Managed Funds Association
The Voice of the Global Alternative Investment Industry
WASHINGTON, DC | NEW YORK

February 27, 2012

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") amendments to proposed new Rule 5123, and the Commission's order instituting proceedings to determine whether to approve or disapprove of the proposed Rule.[2] The SEC requests comment on, among other things, whether the proposed rule change, as amended, is inconsistent with Section 15A(b)(6) or any other provision of the Securities Exchange Act of 1934 (the "Exchange Act"), or the rules thereunder. For the reasons set out below, proposed Rule 5123, as amended, would conflict with Section 15A(b)(6), Section 3(f) and Section 19(b)(2) of the Exchange Act.

In our previous letter,[3] we explained that Rule 5123 as originally proposed would conflict with the long-standing framework for the regulation of private fund offerings by requiring that issuers disclose particular information to purchasers of interests in a private fund. Such a requirement would be inconsistent with both Section 4(2) of the Securities Act of 1933 (the

[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 $2 trillion invested in absolute return strategies. MFA is headquartered in Washington, D.C., with an office in New York.

[2] Notice of Filing of Partial Amendment No. 1 and Order Instituting Proceedings to Determine Whether to Approve or Disapprove a Proposed Rule Change, as modified by Partial Amendment No. 1, to Adopt FINRA Rule 5123 (Private Placements of Securities), Securities Exchange Act Release No. 66203 (Jan. 20, 2012), 77 F.R. 4065 (Jan. 26, 2012); *see also* 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).

[3] Letter from Stuart J. Kaswell, Executive Vice President & Managing Director, General Counsel, MFA, to Elizabeth Murphy, Secretary, Securities and Exchange Commission (Nov. 14, 2011), available at: https://www.managedfunds.org/wp-content/uploads/2011/11/MFA_Comments_on_FINRA_Rule5123.pdf.

"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). In addition, by requiring a FINRA member that offers or sells private placements to provide disclosures to each investor prior to sale, and to file disclosure documents with FINRA, the Rule would make private offerings more costly and less efficient, thereby imposing an unnecessary burden on capital formation. Accordingly, as originally proposed, Rule 5123 would conflict with Section 15A(b)(6), Section 3(f) and Section 19(b)(2) of the Exchange Act,[4] and we recommended that the SEC disapprove the proposed Rule.

The proposed amendments to Rule 5123 would not cure these fundamental deficiencies; the amended Rule would still conflict with the statutory framework for private placements generally and for offerings by private funds specifically, and would impose an unnecessary burden on capital formation. We therefore recommend that the SEC disapprove the amended Rule.

Rule 5123, as amended, is inconsistent with the federal securities laws because it would mandate that issuers disclose particular information in connection with a private offering. As we explained in our previous letter, 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 SEC, in interpreting and applying the private offering exemption in Section 4(2) of the Securities Act, has likewise not imposed substantive disclosure requirements on private offerings. Instead, the SEC adopted Regulation D under the Securities Act to provide a safe harbor for private issuers seeking to comply with Section 4(2). While Regulation D includes certain types of offering restrictions, it does not prescribe the type of information that issuers must disclose in connection with a private offering.[5]

In addition, Congress and the SEC have determined not to require private funds that rely on the exemption from the definition of "investment company" in Section 3(c)(7) of the Investment Company Act of 1940 (the "Investment Company Act") to disclose specific information to investors. The National Securities Markets Improvement Act of 1996 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."[6] The Commission regards transactions that comply with Rule 506 of Regulation

[4] 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 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.

[5] Regulation D requires an issuer to provide certain information only to a purchaser that is not an accredited investor. Rule 502(b).

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

D as non-public offerings for purposes of Section 3(c)(7).[7] As a result, both Congress and the SEC have determined not to require private funds that rely on Section 3(c)(7) to disclose particular information to investors.

Rule 5123, as amended, would conflict with this statutory and regulatory framework for 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, and the safe harbor under Regulation D. In conducting private offerings, hedge funds meet the requirements of Section 4(2) and Regulation D and provide 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.[8]

FINRA proposes to amend Rule 5123 to no longer require the creation and delivery of a disclosure document in connection with sales in which no private placement memorandum, term sheet or disclosure document is used. This change, however, would not address the fundamental conflict with the federal securities laws resulting from requiring substantive disclosure in connection with a private offering. FINRA's proposal would substitute its judgment for Congress, which has enacted and repeatedly reaffirmed a statutory framework for private funds that leave matters of disclosure to issuers and the sophisticated investors who are eligible purchasers.

In its letter, FINRA explains that the proposed Rule would be helpful in light of instances of fraud in the private placement market. MFA members depend on fair, honest markets to conduct their businesses, and we strongly support regulatory efforts to identify and punish fraudulent behavior. We believe the existing framework for the regulation of private offerings, including the broad anti-fraud provisions of the federal securities laws and rules thereunder, reflects the clear intent of Congress to prevent abusive conduct and provide the SEC with authority to identify and punish inappropriate activity by issuers. Congress has not included within this framework mandatory types of disclosures for private offerings to sophisticated investors. Accordingly, FINRA's proposal – however well-intentioned – purports 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 the Congress has enacted in the Investment Company Act, the Securities Act and the Exchange Act.[9]

---

[7] *See* Privately Offered Investment Companies, Investment Company Act Release No. 22597 at n. 5 (Apr. 3, 1997), 62 F.R. 17512 (Apr. 9, 1997).

[8] 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.

[9] 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.

The amended Rule would also conflict with the findings that the Commission must make under Section 3(f) of the Exchange Act, including whether the proposed Rule would promote efficiency, competition, and capital formation. By requiring a FINRA member that offers or sells private placements to provide disclosures to each investor prior to sale, and to file disclosure documents with FINRA, 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.[10]

In our previous letter, we explained that the Rule should be amended to exempt offerings by private funds that rely on exemptions from the definition of "investment company" in Section 3(c)(1) or 3(c)(7) of the Investment Company Act. Investors in hedge funds that rely on either Section 3(c)(1) or Section 3(c)(7) are sophisticated individuals and institutions that generally must qualify under the federal securities laws as "accredited investors," "qualified clients," or "qualified purchasers."[11] These sophistication standards are designed to ensure that investors with the financial wherewithal to understand and evaluate investments are able to purchase interests in private offerings. These investors typically perform extensive due diligence prior to investing, and obtain detailed information about an offering when making their investment decision.

The amended Rule would not provide an exemption for offerings by Section 3(c)(1) or Section 3(c)(7) funds. Instead, the Rule would include limited exemptions for offerings made to "knowledgeable employees," as defined in Rule 3c-5 under the Investment Company Act, or a new category of investor referred to as "institutional" accredited investors, which would include investors that meet the requirements of Rule 501(a)(1), (2), (3) or (7) of Regulation D.[12] These amendments

---

[10] 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.

[11] "Accredited investor" is defined in Rule 501(a) of Regulation D; "qualified client" is defined in Rule 205-3 under the Investment Advisers Act of 1940; "qualified purchaser" is defined in Section 2(a)(51) of the Investment Company Act.

[12] It is unclear upon what basis FINRA would propose to distinguish "institutional" accredited investors from other types of accredited investors. In adopting Regulation D, the SEC determined the thresholds at which institutions and other types of investors qualify as accredited investors, and FINRA's proposal would substitute its judgment

would have little, if any, effect on the burden on capital formation that would be imposed on hedge funds because these exemptions would apply only to certain investors who are eligible to purchase interests in hedge funds, and not to all eligible purchasers. As a result, hedge funds would often be subject to the Rule, and all funds would need to determine whether they are subject to the Rule or able to rely on an exemption on an investor-by-investor basis.[13] In particular, Section 3(c)(1) funds would generally be subject to the Rule because they may sell interests to accredited investors other than the institutional accredited investors described in the proposed Rule. Fund managers would therefore generally need to prepare the required disclosures, conduct legal analyses to determine which investors should receive the disclosures, and coordinate with FINRA members to ensure timely delivery of disclosure documents to FINRA. Accordingly, the proposed amendments to the Rule would generally not reduce the compliance burden on funds, and the Rule would impair capital raising by hedge funds in a manner that is inconsistent with Section 3(f) of the Exchange Act.

The burdens imposed by the proposed Rule on hedge funds and other issuers would increase the costs of engaging a member of FINRA in connection with a private offering. Hedge fund managers that engage a FINRA member and become subject to the Rule would need to, at a minimum, determine what information must be provided to investors under the Rule, ensure that the required information is disclosed to investors by amending an existing private placement memorandum, and make arrangements with a FINRA member to ensure that disclosure documents are properly and timely filed with FINRA. If the Rule were adopted, a fund manager conducting a private offering would need to carefully evaluate whether these additional regulatory requirements and expenses are in the best interests of fund investors, or whether fund offerings instead could be conducted effectively in a manner that would not incur these burdens.

Currently, the decision of a hedge fund manager to engage the services of a FINRA member in connection with a fund offering is based on a wide range of business considerations, including the investment strategy of the fund, expected types of investors, and other operational and administrative characteristics of the fund. The proposed Rule would impact this decision-making process and discourage a hedge fund manager from engaging a FINRA member due to regulatory requirements, rather than business considerations. We are concerned that imposing regulatory considerations on current offering practices in this manner would be harmful to capital formation, and would not be in the best interests of investors.

Furthermore, by discouraging a fund manager from engaging a FINRA member in connection with an offering, the proposed Rule would likely have the unintended effect of reducing the number of hedge fund offerings that are made with the participation of a registered broker-dealer firm. The SEC recognizes a similar concern in its order by asking whether the proposed Rule would encourage issuers to utilize unregistered firms to effect their covered offerings. In our view, the costs imposed by the Rule would discourage issuers from using FINRA members to effect offerings, and could therefore lead to a reduction in the use of registered broker-dealer firms in connection with

---

for that of the Commission by determining that only certain accredited investors should be exempt under the Rule. Such a new category of investors would also cause unnecessary complexity and confusion for issuers.

[13] For example, Section 3(c)(1) funds that sell interests to accredited investors who are natural persons would be subject to the Rule, as would Section 3(c)(7) funds that sell interests to persons that are neither "qualified purchasers" nor "knowledgeable employees," such as certain non-U.S. persons or investors that meet the terms of Rule 3c-5(b) under the Investment Company Act.

private offerings. Such a reduction in the use of registered broker-dealers could create uncertainty for issuers and regulators, and would not further the policy objectives of the Rule.

For these reasons, we believe amended Rule 5123 would conflict with Section 15A(b)(6), Section 3(f), and Section 19(b)(2) of the Exchange Act. In particular, the proposed amendments – and similar types of modest changes – would only affect the Rule at the margins, and would not alter its inconsistency with the framework for the regulation of private offerings established by Congress. We recommend that the Commission disapprove of Rule 5123, as amended, pursuant to Section 19(b)(2), which 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 directs the Commission to disapprove a proposed rule change if it does not satisfy such standard.

* * * * * * *

MFA appreciates the opportunity to provide comments to the Commission in response to its order instituting proceedings to determine whether to approve or disapprove of 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, Associate General Counsel, or the undersigned at (202) 730-2600.

Respectfully submitted,

/s/ Stuart J. Kaswell

Stuart J. Kaswell
Executive Vice President & Managing Director,
General Counsel

Cc: Marc Menchel, Executive Vice President and General Counsel for Regulation, FINRA