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February 7, 2012

The Honorable Mary L. Schapiro
Chairman
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-9303

Re: Rulemaking Petition File No. 4-643: Request by MFA for Rulemaking to Amend Rule 502(c) of Regulation D to Eliminate the Prohibition on Offers or Sales of Securities by General Solicitation or General Advertising With Respect to Private Funds

Dear Chairman Schapiro:

On January 9, 2012, the Managed Funds Association (MFA) submitted a rulemaking petition asking the Commission to eliminate the prohibition on general solicitation and general advertising in connection with securities offerings by unregistered private funds.[1] We strongly oppose this petition, and indeed would oppose *any* rule that would weaken the fundamental statutory requirement that a private fund must not make a public offer of its securities.[2]

We recognize that private funds offer important benefits to investors and financial markets alike. Many registered investment companies invest in private funds, and many ICI member firms sponsor both investment companies and private funds. Accordingly, our opposition does not stem from a competitive "us versus them" concern. Rather, it reflects a strong conviction that maintaining the distinctions between investment companies and private funds as Congress intended serves the interests of *all* investors. Permitting private funds to advertise publicly would represent a dangerous erosion of these distinctions. Such permission is neither necessary nor appropriate in the public

[1] Request for Rulemaking to Amend Rule 502(c) of Regulation D to Eliminate the Prohibition on Offers or Sales of Securities by General Solicitation or General Advertising with Respect to Private Funds, submitted by Richard H. Baker, President and CEO, Managed Funds Association (January 9, 2012), available at http://www.sec.gov/rules/petitions/2012/petn4-643.pdf (the "Petition").

[2] For a more thorough discussion of the Institute's position, *see* Letter from Paul Schott Stevens, President and CEO, Investment Company Institute, to Nancy M. Morris, Secretary, Securities and Exchange Commission, dated Oct. 9, 2007 (providing comments on the Commission's proposal to reform Regulation D), available at http://www.ici.org/pdf/21825.pdf (the "Reg D Comment Letter").

interest, nor consistent with the protection of investors. For these reasons, more fully described below, we respectfully urge that the Commission deny MFA's rulemaking petition.

Prohibition on Public Offerings

The decades-old prohibition on general solicitation and general advertising follows directly from the statutory requirement that a private fund, in order to avoid regulation as an investment company, must not be making or presently propose to make a public *offer* of its securities.[3] As the Commission long ago determined:

> Negotiations or conversations with or general solicitations of an unrestricted and unrelated group of prospective purchasers for the purpose of ascertaining who would be willing to accept an offer of securities is inconsistent with a claim that the transaction does not involve a public offering even though ultimately there may only be a few knowledgeable purchasers . . . Public advertising of the offerings would, of course, be incompatible with a claim of a private offering.[4]

Allowing private funds to solicit, or advertise to, investors generally would contravene Congressional intent by effectively reading the "no public offering" requirement out of the statute altogether.

MFA's Arguments for Eliminating the Ban on General Solicitation and General Advertising

In its Petition, MFA claims that allowing private funds to advertise serves public policy purposes. We strongly disagree. MFA offers four possible arguments along these lines, none of which is compelling:

- First, after years of seeking to avoid registration under the Investment Advisers Act, hedge fund sponsors, through MFA, now trumpet the need for greater "transparency." MFA asserts that eliminating the ban on private fund advertising would serve this purpose "by leading to disclosure about hedge funds of a different type than regulatory filings."[5] The public dissemination of performance information, according to the Petition, would provide regulators with "an additional resource in seeking to monitor industry trends, understand hedge fund activity, and conduct oversight."[6] It seems apparent that the real motivation here is marketing and product promotion, not the facilitation of enhanced regulatory monitoring. As the Petition acknowledges, the Commission has taken a great many steps in the past year to significantly increase the

[3] *See* Sections 3(c)(1) and 3(c)(7) of the Investment Company Act of 1940, adopted in 1940 and 1996, respectively.

[4] *See* Non-Public Offering Exemption, SEC Rel. No. 33-4552 (Nov. 6, 1962), at text preceding n.2, text preceding n.3.

[5] Petition, at 7.

[6] Id.

transparency of the hedge fund industry and its ability to oversee hedge fund advisers.[7] It is difficult to see how a slew of public advertisements, which Commission staff would have to individually locate and monitor, would provide the Commission or its staff with greater insight than the detailed information required by Form PF or available upon inspection and examination. More generally, no individual adviser's marketing campaign, designed principally to stimulate investor interest in its own private fund offerings, is likely to provide the Commission much useful information about the broader industry.[8]

- Second, MFA argues that eliminating the ban on advertising would not raise investor protection concerns, because private funds may only sell interests to investors meeting certain qualification standards.[9] Its arguments here disguise a far more fundamental issue, referenced earlier in the Petition where MFA states that "changes to the securities markets, technology and regulation have called into question…the need to regulate [Regulation D] offerings, rather than actual sales."[10] The bedrock principle espoused by Congress in 1940 is that private funds must conduct private *offerings*. The Commission has a well-developed body of law and lore addressing what it means to conduct a private offering, including the clear statement in 1962 that "public advertising…would, of course, be incompatible with a claim of a private offering." Hedge funds are not prohibited from general solicitation merely because Rule 502(c) of Regulation D says so, but because general solicitations are inherently incompatible with the statutory basis for their exempt status. To do what MFA asks, which is to eliminate Rule 502(c), would be to collapse altogether the regulatory distinctions between public and private securities offerings. The Commission must carefully consider the potential ramifications of such an action, not just on private funds, but on the very nature of its

[7] These include new registration rules for private fund advisers, new disclosure requirements on Form ADV, and the adoption of reporting requirements on Form PF. *See Rules Implementing Amendments to the Investment Advisers Act* , Release No. IA-3221 (June 22, 2011), available at http://www.sec.gov/rules/final/2011/IA-3221.pdf; and *Reporting by Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisors on Form PF* , Release No. IA-3308 (October 31, 2011), available at http://www.sec.gov/rules/final/2011/ia-3308.pdf.

[8] It is worth noting that the MFA has previously asked that the Commission adopt a rule under the Investment Advisers Act that would allow advisers to private funds to send advertising materials to existing or prospective investors "without being required to comply with the specific limitations set out in SEC and staff guidance applicable to advertising material of investment advisers." *See* Letter from Richard H. Baker, President and CEO, Managed Funds Association, to Christopher Cox, Chairman, U.S. Securities and Exchange Commission, dated April 24, 2008. While that particular request was not part of the Petition, it is not clear that MFA has changed its position in this regard.

[9] Section 3(c)(1) provides an exception from regulation as an investment company for any fund beneficially owned by 100 or fewer investors that is not making a public offering of the securities it issues, and Section 3(c)(7) of the Investment Company Act provides a similar exception for any fund owned solely by qualified purchasers. Rule 205-3 under the Investment Advisers Act permits funds to charge performance fees if all investors are "qualified clients."

[10] Petition, at 6.

regulation of all private securities offerings.

- Third, MFA argues that eliminating the ban would reduce costs of regulatory oversight, allowing the Commission's staff to reallocate its resources to other important aspects of investor protection. While we agree that the prohibition on general solicitation and general advertising may from time to time raise difficult legal and interpretive questions, simply removing the ban is no way to resolve them. A simple analogy proves the point: the staff often is called upon to consider no-action assurances or exemptive relief relating to the prohibitions on affiliated transactions in Section 17 of the Investment Company Act. The issues can be complex, and might take months or even years to resolve. No one would argue, however, that it would "free up valuable resources" to simply strike Section 17 from the books.

- Fourth, MFA argues that allowing private funds to advertise would enhance capital formation and reduce administrative costs, by, among other things, reducing the cost of capital for private funds and making private offerings more efficient. This is no doubt true, and indeed likely lies at the heart of the Petition. Simply put, hedge fund sponsors want to advertise because it will make it easier for them to raise capital, increase the size and number of their funds, expand their market penetration, and increase their revenues—all worthy business objectives, perhaps, but hardly a justification for such a dramatic shift in regulatory policy.

Indeed, none of MFA's arguments provide a compelling basis for the Commission to reconsider its longstanding interpretation of the "no public offering" requirement. Rather, there are compelling policy reasons for the Commission to *reaffirm* the prohibition against general solicitation and general advertising in private fund offerings. The registration and other requirements of the Investment Company Act were developed first and foremost to protect fund investors. The Commission should consider carefully whether it would create perverse incentives to avoid registration if the sponsor of a private fund were permitted to market its fund no less widely than the sponsor of a registered fund. Moreover, public marketing of private funds would surely cause investors to confuse such funds with registered, highly regulated investment companies.[11] And it would present greater opportunities for perpetrators of securities fraud to identify and target unsophisticated investors.[12] This potential for investor confusion and fraudulent activity would be compounded by the fact that the Commission

[11] *See, e.g.*, "False Media Reports Roil Money Market Funds," IGNITES (Aug. 15, 2007) (describing how erroneous press reports that a registered money market fund had suspended redemptions sparked broad market selling, when in fact the fund at issue was an unregistered cash management pool that serviced hedge funds and commodity trading firms).

[12] Past history shows that this is a very real threat. *See, e.g.*, Reg. D Comment Letter, *supra* note 2, at 8 (discussing the Commission's 1992 decision to allow general solicitation and general advertising in so-called "seed capital" offerings under Rule 504 of Regulation D, and its reversal of that decision in 1999, based on concerns that public marketing was exacerbating opportunities for microcap fraud).

simply would not have the resources to monitor advertisements by private funds—whether legitimate or fraudulent—in any meaningful way.

Moreover, the MFA's apparent premise—that private funds need general solicitation or general advertising to identify and communicate effectively with potential investors, and that they are unduly burdened by having to direct their communications only to sophisticated investors—is demonstrably false. According to Hedge Fund Research, Inc., in 2000, there were around 3,300 hedge funds with about $490 billion in assets under management, and in 2010, there were around 7,000 funds with $1.6 trillion in assets under management.[13] During this past year, hedge fund assets grew to $2.01 trillion, having attracted $70 billion of net new capital.[14] The rapid growth of the private fund industry over the last decade belies any suggestion that they are unable to effectively reach potential investors.

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We appreciate your consideration of the Institute's views on this Petition. If you have any questions or wish to discuss these issues further, please contact me directly at 202/326-5901 or Karrie McMillan, General Counsel of the Institute, at 202/326-5815.

Sincerely,

/s/

Paul Schott Stevens
President & CEO

cc: The Honorable Mary L. Schapiro
The Honorable Elisse B. Walter
The Honorable Luis A. Aguilar
The Honorable Troy A. Paredes
The Honorable Daniel M. Gallagher, Jr.

Eileen P. Rominger, Director
Douglas J. Scheidt, Associate Director and Chief Counsel
Division of Investment Management

[13] Hedge Fund Research, Inc., "2010 Q2 Hedge Fund Industry Report," HFR Global Hedge Fund Industry Reports, (Chicago, Ill., 2011), www.hedgefundresearch.com, cited in GAO's Report on Private Fund Advisers (June 2011), available at http://www.gao.gov/new.items/d11623.pdf.

[14] Hedge Fund Research, Inc., press release, "Hedge Fund Investors Rotate Into Macro, Arbitrage Strategies for 2012" (Jan. 19, 2012), available at https://www.hedgefundresearch.com/pdf/pr_20120119.pdf.