

October 9, 2007

Ms. Nancy M. Morris  
Secretary  
U.S. Securities and Exchange Commission  
100 F Street, N.E.  
Washington, D.C. 20549-9303

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

Dear Ms. Morris:

The Investment Company Institute<sup>1</sup> appreciates this opportunity to comment on the Commission's proposed amendments to Regulation D under the Securities Act of 1933, in particular the limited advertising provision of proposed Rule 507.<sup>2</sup> The Institute strongly opposes this provision because it represents a dangerous erosion of the long-established line between public and private securities offerings. Moreover, we believe the Commission has failed to demonstrate that allowing limited advertisements for private securities offerings is necessary or appropriate in the public interest and consistent with the protection of investors.

If the Commission nevertheless determines to adopt Rule 507, the Institute urges that the rule be adopted substantially as proposed. As the Proposing Release indicates, one consequence of the Commission's approach is that pooled investment vehicles excluded from the definition of "investment company" under the Investment Company Act of 1940 (collectively, "private investment pools") would not be able to rely on Rule 507. The Institute firmly believes that this is the appropriate result, for compelling legal and policy reasons. We further recommend that the Commission take this opportunity to reiterate that allowing any form of general solicitation or general advertising by private investment pools is fundamentally inconsistent with their exclusion from the Investment Company Act.

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<sup>1</sup> The Investment Company Institute is the national association of the U.S. investment company industry. More information about the Institute is available at the end of this letter.

<sup>2</sup> SEC Release Nos. 33-8828 and IC-27922 (Aug. 3, 2007), 72 Fed. Reg. 45116 (Aug. 10, 2007) ("Proposing Release"). Page number citations in this letter reference the Proposing Release as posted on the Commission's website, which is available at <http://www.sec.gov/rules/proposed/2007/33-8828.pdf>.

These positions, which are outlined in detail below, reflect the Institute's firm conviction that the Commission must maintain a strict demarcation between public and private offerings of securities. No less strong is our belief that the Commission must ensure the highest level of investor protection possible with respect to unregistered offerings of securities. In keeping with these broad principles, the Institute recommends that the Commission take the following courses of action in addressing selected other aspects of its proposal:

- Adopt the proposed "accredited natural person" standard for investors in private investment pools organized under Section 3(c)(1) of the Investment Company Act, but without an exclusion for venture capital funds.<sup>3</sup>
- Adjust all dollar thresholds in the accredited investor standards in Rule 501 of Regulation D by making: (1) an immediate adjustment that would correct for the substantial erosion in those standards over the period from 1982, when they were first adopted, to the present; and (2) regular adjustments every five years thereafter to prevent future erosion. The dollar thresholds in the accredited natural person standard in proposed Rule 509 of Regulation D should be similarly adjusted every five years.<sup>4</sup>
- Adopt the proposed "bad actor" disqualification provisions for all securities offerings under Regulation D.
- Continue to exclude manner of sale violations from the list of insignificant deviations from Regulation D in Rule 508.<sup>5</sup>

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<sup>3</sup> Our position on this proposed standard is discussed more fully on pages 12-13 and in the comment letter filed by the Institute when this provision was first proposed in 2006. *See infra* note 31. *See also* Commissioner Paul S. Atkins, Remarks Before the Federal Reserve Bank of Chicago Seventh Annual Private Equity Conference (Aug. 2, 2007), available at <http://www.sec.gov/news/speech/2007/spch080207psa.htm> (questioning whether there is a "principled reason" for treating venture capital funds differently and suggesting that such funds "should not get too comfortable with their exclusion").

The Institute recognizes that several different sophistication standards already exist for specific types of exempt transactions (e.g., "qualified purchaser," "qualified client," "qualified institutional buyer") and that the adoption of yet two more – "accredited natural person" and "large accredited investor" – would increase complexity for issuers and could have the unintended effect of causing compliance failures. The Institute would support an effort to harmonize the various standards for investing in offerings intended for sophisticated investors, and ultimately reduce the number of such standards, provided that investment thresholds remain high and there is no reduction in investor protection.

<sup>4</sup> Our position on this issue is discussed more fully on pages 14-15.

<sup>5</sup> *See* Proposing Release at 24 (specifically requesting comment on whether the Commission should "delete the current Rule 508 carve-out of manner of sale limitations in the list of insignificant deviations").

## **Publication of Limited Announcements Under Proposed Rule 507**

### **1. Publication of Rule 507 Limited Announcements would be Inconsistent with the Longstanding Prohibition Against General Solicitation and General Advertising in Unlimited Offerings of Unregistered Securities**

Proposed Rule 507 would establish a new exemption from Securities Act registration for certain offerings to “large accredited investors,” as defined in the rule. It would allow private issuers – for the first time – to publish tombstone-like announcements in print media and on the Internet to facilitate the sale of an unlimited amount of unregistered securities to eligible investors.

The Rule 507 proposal represents a dramatic departure from the Commission’s longstanding, and logical, position that general solicitation or general advertising is not permissible as part of an offering of unregistered securities. Until this proposal, the Commission had always considered an offering of unregistered securities that is unlimited as to the amount offered to be a *private* offering – or more precisely, a transaction “not involving any public offering” within the meaning of Section 4(2) of the Securities Act – if conducted under the express conditions of Regulation D or the more limited conditions applicable to offerings under Section 4(2). In a 1962 release discussing the scope of the Section 4(2) exemption, the Commission explained that whether a transaction does not involve a public offering is a question of fact, based upon consideration of all surrounding circumstances.<sup>6</sup> On the issues of solicitation and advertising, the Commission stated:

Consideration must be given not only to the identity of the actual purchasers but also to *the offerees*. 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.<sup>7</sup>

This interpretation of the private offering exemption has remained essentially unchanged for the last 45 years.

The Commission now attempts to walk a fine line in this proposal by seeking to allow public announcements in connection with unlimited, unregistered securities offerings, yet not disturb its

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<sup>6</sup> See Non-Public Offering Exemption, SEC Rel. No. 33-4552 (Nov. 6, 1962).

<sup>7</sup> *Id.* at text preceding n.2, text preceding n.3 (emphasis added).

longstanding interpretation of the “no public offering” exemption in Section 4(2). It attempts to do so by promulgating Rule 507 pursuant to its general exemptive authority in Section 28 of the Securities Act, which would permit adoption of the rule upon a finding by the Commission that Rule 507 is “necessary or appropriate in the public interest and consistent with the protection of investors.”<sup>8</sup> This procedural posture cannot hide the fact that the Commission’s proposal would erode the critical distinction between public and private securities offerings. In effect, the Commission is attempting to do indirectly what it prefers not to do directly – to provide an exemption from Securities Act registration that is at odds with the Commission’s own longstanding position under Section 4(2).

This approach strikes us as highly problematic, on both legal and policy grounds. First, the Commission has analyzed whether proposed Rule 507 meets the Section 28 standard for exemption by reference to the standard articulated in *Ralston Purina*, the seminal Supreme Court case interpreting Section 4(2).<sup>9</sup> Incorporating the Section 4(2) standard into Rule 507 – and at the same time expressing the desire not to disturb the Commission’s historical position – would seem to invite years of difficult interpretations of Section 4(2), which has been one of the critical underpinnings of the distinction between “public” and “private” offerings since passage of the Securities Act.

It also is a first step down a very slippery slope. By allowing announcements of what should be private securities offerings to be published in print media and on the Internet, the Commission would take a large and fateful first step down a regulatory path toward a “public offer, private sale” regime.<sup>10</sup> If such a regime came to pass, regulatory protections for unregistered offerings of securities would focus solely on persons who ultimately *purchase* those securities. This would appear to be fundamentally at odds with the statutory scheme crafted by Congress in 1933, which has as a central premise that *offers* are worthy of regulation, and regulating after the fact provides insufficient safeguards for the American public. The Institute thus views the adoption of Rule 507 as a treacherous path that, once embarked upon, will over time erode the important investor protection provisions and safeguards intended by the Securities Act.

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<sup>8</sup> “Because some advertising would be permitted in Rule 507 transactions, we have chosen not to propose the exemption under Section 4(2) of the Securities Act, which the Commission in the past has viewed as incompatible with a non-public offering under Section 4(2).” Proposing Release at n.75.

<sup>9</sup> See Proposing Release at n.74 (“The conclusion that investors do not need all the protections that registration under the Securities Act would offer them and that they can fend for themselves is the determination that must be made under *SEC v. Ralston Purina*, 346 U.S. 119, 125 (1953), to establish that transactions are exempt under Section 4(2) of the Securities Act as transactions ‘not involving any public offering.’ We believe the *Ralston Purina* standard is informative in analyzing whether Rule 507, as proposed, would satisfy the Section 28 standard.”).

<sup>10</sup> The Commission has received specific requests for regulatory reform that would effectively create a “public offer, private sale” regime. See, e.g., Letter from Keith Higgins, Chair, Committee on Federal Regulation of Securities, American Bar Association, to John W. White, Director, Division of Corporation Finance, Securities and Exchange Commission, dated March 22, 2007 (recommending comprehensive reform of private securities offerings).

**2. The Commission Has Failed to Demonstrate that the Limited Announcement Provision of Rule 507 is “Necessary or Appropriate in the Public Interest and Consistent with the Protection of Investors,” as Required by Section 28 of the Securities Act**

*No Showing that Rule 507 Advertisements are Necessary or Appropriate in the Public Interest*

The Proposing Release contains little discussion as to why the Commission believes that tombstone-like advertisements of unlimited, unregistered securities offerings are necessary. There is no suggestion in the Proposing Release, for example, that private issuers of securities are unable to find potential investors using existing means, or that issuers have inordinate difficulty in complying with the prohibition on general solicitation and general advertising. It also would seem difficult to conclude that Rule 507 advertisements are necessary when, in fact, the Commission staff has in recent years interpreted the prohibition on general solicitation and general advertising with some flexibility, to take into account the widespread use of the Internet and other changes in communications technology.<sup>11</sup>

The Proposing Release seems to suggest that the limited announcement provision in Rule 507 would be appropriate in the public interest because it is modeled on the public advertising that is permitted today in selected types of securities offerings exempt from registration under the Securities Act and applicable state securities laws. Specifically referenced in the Proposing Release are the limited announcements that are allowed by the Securities Act exemption in Rule 1001 of Regulation CE, which is specific to limited offerings conducted under California’s “qualified purchaser exemption.”<sup>12</sup> The Proposing Release also indirectly references the limited announcements allowed in limited

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<sup>11</sup> See, e.g., IPONET (July 26, 1996) (general solicitation is not present when previously unknown investors are invited to complete a web-based questionnaire, and are provided access to private offerings via a password-protected website only if a broker-dealer makes a determination that the investor is accredited under Regulation D); Lamp Technologies, Inc. (May 29, 1998) (posting of information on a password-protected website about offerings by private investment pools, when access to the website is restricted to accredited investors, would not involve general solicitation or general advertising under Regulation D). These interpretive positions took care to preserve the private offering distinction and its related protections.

<sup>12</sup> See Proposing Release at n.61 (“We already have one federal exemption from Securities Act registration that permits offerings involving select investors and a limited amount of general solicitation.”).

offerings to accredited investors that are conducted pursuant to Rule 504 of Regulation D and individual state laws.<sup>13</sup>

What the Proposing Release fails to acknowledge explicitly, however, is that the applicable Securities Act exemptions for these limited offerings were promulgated by the Commission under Section 3(b) of the Securities Act, commonly referred to as the “small issue” exemption. Section 3(b) allows the Commission to exempt from the Securities Act any class of securities upon finding that enforcement of the Securities Act with respect to those securities “is not necessary in the public interest and for the protection of investors by reason of the small amount involved or the limited character of the public offering.” As recently as 1980, Congress revisited the “small issue” exemption and determined that it was appropriate to set the ceiling for Section 3(b) offerings at \$5 million. It is thus reasonable to infer from this action that Congress did not intend for unregistered public offerings to involve an unlimited amount of securities. On this basis, we believe that the limited announcements allowed in Section 3(b) offerings to facilitate access by small issuers to the capital markets bear no reasonable relationship to the question of whether it is appropriate to allow limited public announcements under Rule 507.

*No Showing that Rule 507 Advertisements are Consistent with the Protection of Investors*

To satisfy the standard for exemption set forth in Section 28 of the Securities Act, the Commission also must demonstrate that the limited public advertising envisioned by Rule 507 is “consistent with the protection of investors.” The Proposing Release states that the rule satisfies this standard, in relevant part, because it “impose[s] strict controls on advertising.”<sup>14</sup> The Proposing Release further explains that Rule 507 advertisements would be limited to written form “in an effort to limit aggressive selling efforts made through the announcement” and, accordingly, that “radio or television

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<sup>13</sup> Rule 504(b)(1)(iii) under Regulation D allows offerings made exclusively according to state law exemptions from registration that permit general solicitation and general advertising provided that sales are made only to accredited investors. This provision of Regulation D is not discussed directly in the Proposing Release. Rather, the Proposing Release focuses on the Model Accredited Investor Exemption approved by the North American Securities Administrators’ Association (“NASAA”) in 1997, which has served as the template for over 30 state laws that work in conjunction with Rule 504(b)(1)(iii). *See, e.g.*, Letter on behalf of NASAA from Patricia D. Struck, NASAA President and Wisconsin Securities Administrator, to Nancy M. Morris, Federal Advisory Committee Management Officer, Securities and Exchange Commission, dated March 28, 2006, at n.2 (commenting on the draft report by the Advisory Committee on Smaller Public Companies). The Proposing Release states that the limited announcement provision of Rule 507 is “substantially patterned” after the advertising provision contained in the NASAA model exemption. *See* Proposing Release at n.59.

<sup>14</sup> *See* Proposing Release at 26-27.

broadcast spots or ‘infomercials’ would be prohibited.”<sup>15</sup> In this era of technological advances, however, the line between written materials – which have been viewed as including the Internet – and broadcast – which traditionally has had a multi-media component – has been blurred. It is difficult to determine how the Commission could satisfy itself that its intended limitations would, in fact, provide the necessary protections.

The Proposing Release, moreover, tells just half the story, by focusing on what the proposal would not allow. In the Institute’s view, it is more important to focus on what the proposal *would* allow – namely, advertisements made broadly available in print media and on the Internet for all to see, announcing unlimited offerings of unregistered securities. Viewed from this perspective, it is clear that the Commission’s proposal would have the overall effect of reducing the safeguards that have been in place for more than 45 years to protect the general public from the heightened risks associated with unregistered securities offerings.

Although Rule 507 is presumably intended to make it easier for private issuers to locate eligible investors, the public advertising contemplated for Rule 507 offerings would surely have the effect of stimulating demand for these securities among ineligible investors as well. The Commission clearly recognizes this risk and, in fact, states in the Proposing Release that it attempted to craft the proposed rule “in a manner that is cognizant of the potential harm of offerings by unscrupulous issuers or promoters who might take advantage of more open solicitation and advertising to lure unsophisticated investors to make investments in exempt offerings that do not provide all the benefits of Securities Act registration.”<sup>16</sup> In the Institute’s view, the potential for this type of harm should, in and of itself, be sufficient reason for the Commission – in accordance with its investor protection mandate – to maintain a strict prohibition on general solicitation and general advertising in unlimited, unregistered securities offerings.

The Commission’s proposal would have the unintended, yet entirely foreseeable, effect of making it easier for perpetrators of securities fraud to target and defraud the public. The overall increase in announcements for unregistered securities offerings would make it difficult for investors to distinguish between advertisements for legitimate offerings and advertisements for fraudulent schemes. So too would it complicate the Commission’s own compliance and enforcement efforts with regard to unregistered offerings, which remain subject to the antifraud and civil liability provisions of the federal securities laws, because the Commission is unlikely to have the requisite level of resources to monitor this proliferation of advertisements in a meaningful way.

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<sup>15</sup> See Proposing Release at 20. The Proposing Release specifically requests comment on a number of ways in which the proposal might be broadened to allow an even greater degree of advertising by, for example: (1) permitting additional information in the announcement; (2) expanding the proposed 25-word limit on the description of the issuer’s business; or (3) allowing radio or television broadcast announcements. See Proposing Release at 21-22. Any such modification would appear to conflict with the Commission’s stated goal of imposing strict controls on the advertising to be permitted under the rule.

<sup>16</sup> See Proposing Release at 11.

Investors lacking in investment sophistication are clearly more vulnerable to fraudulent investment schemes. Last year, NASAA conducted a survey to determine the scope of investment fraud involving seniors. Preliminary results indicate that unregistered securities are among the most pervasive financial products involved in senior investment fraud, accounting for approximately 80% of the senior investment fraud cases in Tennessee and approximately 75% of these cases in California and Maryland.<sup>17</sup> These high numbers suggest that the frauds were specifically targeted to retail investors, who generally would not qualify to invest in legitimate unregistered offerings.

To illuminate further the likelihood of increased fraud, consider the results of the Commission's previous attempt to relax the prohibition on general solicitation and general advertising in unregistered offerings. In 1992, the Commission amended Rule 504 under Regulation D to, among other things, eliminate the manner of sale requirements in the rule and thus expressly permit general solicitation and general advertising in all Rule 504 offerings.<sup>18</sup> A mere seven years later, the Commission reversed course and largely reinstated the prohibition on general solicitation and general advertising for Rule 504 offerings.<sup>19</sup> The Commission's action was prompted by concern that the flexibility it had built into the rule – including by allowing general solicitation of investors – was “being abused by perpetrators of microcap fraud.”<sup>20</sup> Many of the factors that, in the Commission's view, could have exacerbated the opportunities for microcap fraud similarly characterize the conditions that would exist for privately placed securities under proposed Rule 507: unprecedented growth in the capital markets, technological changes (most notably the Internet), and the lack of widely distributed public information about the issuers of the securities.

The Institute firmly believes that the Commission has not provided sufficient justification for a proposal that would effectively diminish existing investor protections with respect to unlimited offerings of unregistered securities. For the reasons outlined above, the Institute strongly urges the Commission to abandon its proposal to allow an easing of the current prohibition on general solicitation and general advertising in connection with such offerings.

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<sup>17</sup> See NASAA Survey Shows Senior Investment Fraud Accounts for Nearly Half of All Complaints Received by State Securities Regulators: Unregistered Securities, Variable and Equity-Indexed Annuities Most Pervasive Financial Products Involved in Senior Investment Fraud (press release by North American Securities Administrators Association, July 17, 2006), available at [http://www.nasaa.org/NASAA\\_Newsroom/Current\\_NASAA\\_Headlines/4998.cfm](http://www.nasaa.org/NASAA_Newsroom/Current_NASAA_Headlines/4998.cfm).

<sup>18</sup> See Small Business Initiatives, SEC Rel. No. 33-6949 (July 30, 1992).

<sup>19</sup> See Revision of Rule 504 of Regulation D, the “Seed Capital” Exemption, SEC Rel. No. 33-7644 (Feb. 25, 1999) (adopting release).

<sup>20</sup> Revision of Rule 504 of Regulation D, the “Seed Capital” Exemption, SEC Rel. No. 33-7541 (May 28, 1998) (proposing release) at text following n.20.



## **Private Investment Pools and the Prohibition Against General Solicitation and General Advertising**

If the Commission chooses to disregard these concerns about its proposal and adopt Rule 507, the Institute nonetheless urges that it adopt the rule no more broadly than proposed. For compelling legal and policy reasons, the Commission was correct *not* to propose a rule that would allow private investment pools to announce their offerings in widely available public media. Further, in light of the hedge fund industry's repeated calls for greater flexibility to advertise, the Institute urges the Commission to reiterate in its adopting release that general solicitation and general advertising are fundamentally inconsistent with the exclusion of hedge funds and other private investment pools from the registration and regulatory requirements of the Investment Company Act.<sup>21</sup>

Private investment pools are effectively outside the purview of the Investment Company Act by reason of Sections 3(c)(1) and 3(c)(7), which require that the pool is not making or proposing to make a public offer of its securities and that those securities are sold only to certain specific groups of investors. These provisions thus place express statutory limits on both the offer and the sale of securities issued by a private investment pool.

The Commission has stated that the "no public offering" requirement in Sections 3(c)(1) and 3(c)(7) should be interpreted consistently with the non-public offering requirement in Section 4(2) of the Securities Act.<sup>22</sup> Private investment pools thus typically offer their shares in accordance with Rule 506 under Regulation D, the safe harbor provision under Section 4(2), which expressly prohibits any form of general solicitation or general advertising in connection with the offering.

Hedge funds and other private investment pools would not be permitted to rely on Rule 507 as proposed. This decision by the Commission predictably will elicit strong objections from the hedge fund community, which for years has argued for unregistered hedge funds to be able to advertise through the public media while remaining free from the regulatory restrictions and shareholder protections imposed by the Investment Company Act. In February 2002, for example, the hedge fund industry asked the Commission to allow limited advertisements in all offerings pursuant to Regulation D.<sup>23</sup> More recently, the hedge fund industry formally requested that the Commission reconsider its

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<sup>21</sup> The Institute further recommends that the Commission revise the text of Rule 507 so that it expressly excludes private investment pools that would be required to register under the Investment Company Act but for Sections 3(c)(1) and 3(c)(7) of that Act. As proposed, this exclusion would be mentioned in a note at the end of the rule, rather than prominently in the rule text itself. The Institute's recommendation would not change the substance of the rule but should facilitate compliance.

<sup>22</sup> See *Privately Offered Investment Companies*, SEC Rel. No. IC-22597 (April 3, 1997), at n.5.

<sup>23</sup> See Letter from John G. Gaine, President, Managed Funds Association, to Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission, dated Feb. 27, 2002, available at <http://www.sec.gov/rules/proposed/s72301/gaine1.htm>.

longstanding prohibition on general solicitation and general advertising in private securities offerings.<sup>24</sup> In addition to this push from the hedge fund industry, the Commission staff itself recommended in 2003 that the Commission consider permitting general solicitation in offerings by hedge funds that rely on the exclusion in Section 3(c)(7) of the Investment Company Act.<sup>25</sup> These developments, taken together, suggest that the time is ripe for the Commission to speak to this issue directly.

As a threshold matter, the Commission should make clear in its adopting release that it cannot simply extend proposed Rule 507 – which was promulgated under the Commission’s exemptive authority in the Securities Act – to include hedge funds and other private investment pools. In order for private investment pools to advertise, the Commission would have to approve an explicit exemption from the “no public offering” requirement in Sections 3(c)(1) and 3(c)(7) of the Investment Company Act. This exemption would have to be promulgated pursuant to the Commission’s general exemptive authority under Section 6(c) of the Investment Company Act, which would require the Commission to find that the exemption is “necessary or appropriate in the public interest and consistent with the protection of investors *and the purposes fairly intended by the policy and provisions of [the Investment Company Act]*” (emphasis added). The Institute submits that the Commission could under no circumstances make the required finding because, as explained below, any form of general solicitation or general advertising by hedge funds and other private investment pools is directly contrary to Congressional intent and would raise serious investor protection concerns.

**1. General Solicitation or General Advertising by Private Investment Pools is Contrary to Congressional Intent**

Allowing hedge funds and other private investment pools organized pursuant to Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act to advertise publicly would contravene the clear intent of Congress in adopting those provisions. Section 3(c)(7) in particular was added to the Investment Company Act just a decade ago, in apparent recognition that the full panoply of investment company regulation is not necessary for private investment pools that are offered and sold only to financially sophisticated investors able to bear the risk of loss associated with investing in a private pool. In adopting Section 3(c)(7), Congress set forth only two criteria for these private investment pools: that they be sold only to “qualified purchasers,” and that they not be permitted to make a public offering of securities. In so doing, Congress generally tracked the language in Section 4(2) of the Securities Act, which the Commission has long interpreted as inconsistent with public advertising.

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<sup>24</sup> See Letter from John G. Gain, President, Managed Funds Association, to Nancy M. Morris, Secretary, U.S. Securities and Exchange Commission, dated July 5, 2007, available at [http://www.managedfunds.org/downloads/MFA\\_comments\\_reg\\_agenda%20July%205th.%202007.pdf](http://www.managedfunds.org/downloads/MFA_comments_reg_agenda%20July%205th.%202007.pdf).

<sup>25</sup> See Implications of the Growth of Hedge Funds, Staff Report to the Securities and Exchange Commission (Sept. 2003) (“Hedge Fund Report”), at 100-01.

In its rulemaking to implement Section 3(c)(7) and related provisions, the Commission observed that “while the legislative history . . . does not explicitly discuss Section 3(c)(7)’s limitation on public offerings by Section 3(c)(7) funds, the limitation appears to reflect Congress’s concerns that unsophisticated individuals not be inadvertently drawn into [such] funds.”<sup>26</sup> A member of Congress intimately involved in this debate later concurred with the Commission’s interpretation in a letter to then Chairman Arthur Levitt. His letter further explained:

In 1996, as part of the National Securities Markets Improvement Act, Congress reaffirmed that hedge funds should not be publicly marketed, specifically adding this restriction to a modernized hedge fund exemption that was included in the final bill. As you will recall, I was one of the authors of this provision . . . I believe that the Congress has appropriately drawn the lines regarding hedge fund marketing, and intend to strongly oppose any effort to liberalize them.<sup>27</sup>

In response, Chairman Levitt wrote:

As you point out, the Investment Company Act of 1940 (the “Act”) was designed to protect unsophisticated investors from the risks of investing in unregulated investment pools, or, as they are commonly called, hedge funds. To that end, the Act prohibits hedge funds from publicly offering their securities and limits investment in such pools to specific groups of investors. The Commission believes that these prohibitions and limitations are appropriate to protect unsophisticated investors. The Commission is committed to ensuring that these protections are properly enforced.<sup>28</sup>

Allowing Section 3(c)(7) funds to advertise would eviscerate half of the statutory limitations adopted just a decade ago – a result no doubt eagerly desired by hedge fund sponsors. The Institute respectfully suggests that it would be inappropriate for the Commission, through its exemptive authority, to adopt such a sweeping change to the regulatory framework so recently adopted by Congress, given that there have been no sweeping changes in the private pool industry since the adoption of Section 3(c)(7) and nothing to suggest that such investor protections are no longer necessary.

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<sup>26</sup> Privately Offered Investment Companies, SEC Rel. No. IC-22597 (April 3, 1997), at n.5.

<sup>27</sup> Letter from Rep. Edward J. Markey (D-Mass.) to SEC Chairman Arthur Levitt, dated Dec. 18, 2000.

<sup>28</sup> Letter from SEC Chairman Arthur Levitt to Rep. Edward J. Markey (D-Mass.), dated Jan. 29, 2001.

## 2. **General Solicitation or General Advertising by Private Investment Pools Would Raise Serious Investor Protection Concerns**

Hedge funds are largely unregulated products that may engage in very risky investment strategies, with virtually no required day-to-day safeguards for investors. They are not subject to any substantive regulation and there are no restrictions on who can start a hedge fund. Indeed, with the exception of the antifraud standards – which have been described by a former Commission official as “too little, too late” for defrauded investors<sup>29</sup> – hedge funds are largely free from direct regulation under the federal securities laws. The fact that unregistered hedge funds operate largely outside of regulation designed to protect the markets and the investing public – including but not limited to registration, disclosure, most reporting requirements, specific conflict of interest prohibitions, and investment limitations – makes it imperative that hedge funds continue to be both offered and sold only to investors who are able to “fend for themselves.”

The Commission recently has taken important action on the “sale” side of this equation, to provide additional protections around who may invest in hedge funds and other private investment pools organized under Section 3(c)(1) of the Investment Company Act. Specifically, the Commission has proposed that natural persons satisfy an additional test to be eligible to invest in a Section 3(c)(1) pool. In addition to demonstrating that he or she has sufficient net worth or income, as is now required, an investor in a Section 3(c)(1) pool also would be required to own at least \$2.5 million in investments. According to the Commission’s proposing release, this new two-step approach would mirror the existing eligibility requirements for investors in hedge funds and other private investment pools organized under Section 3(c)(7). In discussing the need for this additional level of protection, the Commission explained that private investment pools:

... involve risks not generally associated with many other issuers of securities. Not only do private [investment] pools often use complicated strategies, but there is minimal information available about them in the public domain. Accordingly, investors may not have access to the kind of information provided through our system of securities

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<sup>29</sup> As observed by Paul Roye, then Director of the Commission’s Division of Investment Management, “By the time we find out about [an instance of hedge fund fraud], it’s too late. The money’s gone.” See “Roye Indicates Interest in Finding Way to Inspect More of Nation’s Hedge Funds,” BNA 33 Sec. Reg. & L. Rep. (BNA) 1678 (Dec. 3, 2001). According to the article, Roye further observed that Commission staff may not inspect the books and records of hedge funds whose advisers are not registered with the Commission, thus making it difficult to determine whether a hedge fund is violating the antifraud rules.

registration and therefore may find it difficult to appreciate the unique risks of these pools, including those with respect to undisclosed conflicts of interest, complex fee structures, and the higher risk that may accompany such pools' anticipated returns.<sup>30</sup>

The Institute strongly supports this proposal, which would help to ensure that sales of hedge funds and other private investment pools are made only to those investors who have the requisite level of knowledge and financial sophistication and the ability to bear the economic risk of their investment.<sup>31</sup>

Having recognized the heightened risks associated with private pool investments, the Commission should likewise take steps on the "offer" side of the equation, by continuing to ensure that interests in hedge funds and other private investment pools cannot be marketed generally to the public. As indicated by the Commission's experience in attempting to allow general solicitation and general advertising in Rule 504 offerings – and then having to reverse course in the face of increased fraudulent activity<sup>32</sup> – it is entirely foreseeable that any easing of the current prohibition on general solicitation and general advertising in hedge fund offerings would invite more hedge fund fraud, to the detriment of investors and the markets generally. Moreover, as the Commission recently acknowledged, the agency faces continued limitations on its "ability to deter or detect fraud by unregistered hedge fund advisers. We currently rely almost entirely on enforcement actions brought after fraud has occurred and investor assets are gone."<sup>33</sup> This frank assessment suggests that the Commission would be well advised to make full use of the existing tools in its arsenal to limit opportunities for hedge fund fraud *before* it occurs.

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<sup>30</sup> Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles; Accredited Investors in Certain Private Investment Vehicles, SEC Rel. Nos. 33-8766 and IA-2576 (Dec. 27, 2006) at text following n.45. A similar concern was voiced by the Commission staff in 2003, when it observed that "even [investors] meeting the accredited investor standard . . . may not possess the understanding or market power to engage a hedge fund adviser to provide the necessary information to make an informed investment decision." *See* Hedge Fund Report, *supra* note 25, at 81.

<sup>31</sup> *See* Letter from Elizabeth Krentzman, General Counsel, Investment Company Institute, to Nancy M. Morris, Secretary, U.S. Securities and Exchange Commission, dated March 9, 2007 at 2, available at <http://www.sec.gov/comments/s7-25-06/s72506-565.pdf>.

<sup>32</sup> *See supra* notes 18-20 and accompanying text.

<sup>33</sup> Registration Under the Advisers Act of Certain Hedge Fund Advisers, SEC Rel. No. IA-2333 (Dec. 2, 2004) at text preceding n.60. In the course of that rulemaking, the Commission further observed:

Unregistered hedge fund advisers operate largely in the shadows, with little oversight, are subject to the pressures of performance fee arrangements, and in many cases are expected to generate positive returns even in down markets. While these conditions can stimulate a tremendous amount of investment creativity and profit, they are also a perfect medium for the germination and growth of frauds. As we have seen, hedge fund advisers are capable of serious transgressions that can harm ordinary citizens who in many cases are now their ultimate beneficiaries.

Registration Under the Advisers Act of Certain Hedge Fund Advisers, SEC Rel. No. IA-2266 (July 20, 2004) at text accompanying n.64.

One of these tools is continuing to maintain a strict line on prohibiting any form of general solicitation or general advertising – no matter how limited in scope – in connection with hedge fund offerings.

Further, permitting hedge funds and other private investment pools to advertise through media intended to reach a broad public audience, such as newspapers and the Internet, would invariably cause confusion – both for investors and for the marketplace – between registered, highly regulated investment companies and unregistered, largely unregulated private pools. This confusion is likely to exacerbate already imprecise uses of “fund” and “money market fund” to refer to investment pools, whether registered or not.<sup>34</sup> Trouble in the hedge fund area that bleeds over in the public’s mind to include mutual funds could shake public confidence in those regulated products, which serve as the primary investment vehicle for over half of all U.S. households.

### **Adjustments to Accredited Investor and Accredited Natural Person Standards**

The Commission proposes to adjust for inflation – on a going forward basis – all dollar-amount thresholds in the accredited investor standards of Rule 501 under Regulation D and in the definition of “accredited natural person” in proposed Rule 509 of Regulation D. As proposed, these adjustments would occur at five-year intervals beginning in July 2012 and would reflect changes in the value of a widely-used index that tracks consumer prices. The Institute strongly supports the Commission’s stated goal of “adjusting the thresholds for inflation in the future . . . [in order to] retain the income, assets, and investments requirements in real terms so that the accredited investor standards will not erode over time.”<sup>35</sup> We believe that the Commission’s proposal, however, would fall short of achieving this goal, because simply adjusting the dollar thresholds to account for consumer price inflation would not sufficiently protect against erosion of these thresholds due to wage inflation or asset appreciation, both of which have historically outpaced increases in consumer prices.

A better approach, in the Institute’s view, would be to require the Commission’s Office of Economic Analysis (“OEA”) to reset the thresholds every five years so that the percentage of the population qualifying as accredited investors or accredited natural persons would remain stable over time. This would entail a straightforward economic analysis that could be performed using widely available government databases. OEA performed this same type of analysis, based upon data from the Federal Reserve Board’s Survey of Consumer Finances, in connection with defining the thresholds for the “large accredited investor” standard. As the Proposing Release indicates, those thresholds were chosen so as to approximate – in today’s dollars – the standards that were set by the Commission in 1982 for accredited investors.<sup>36</sup>

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<sup>34</sup> See, e.g., “False Media Reports Roil Money Market Funds,” IGNITES (Aug. 15, 2007) (describing how press reports that erroneously identified an unregistered cash management pool as a money market mutual fund sparked selling in three major indexes, after the unregistered pool halted redemptions).

<sup>35</sup> See Proposing Release at 43.

<sup>36</sup> See Proposing Release at nn. 50-51 and accompanying text.

The Institute believes, moreover, that the Commission's proposal would not go far enough, because it would make no adjustment to the accredited investor standards in Rule 501 to correct for the substantial erosion that has occurred during the period from 1982, when the standards were adopted, to the present day. This is despite the express acknowledgement in the Proposing Release that "inflation, along with the sustained growth in wealth and income of the 1990s, has boosted a substantial number of investors past the 'accredited investor' standard. By not adjusting these dollar-amount thresholds upward for inflation, we have effectively lowered the thresholds . . ."<sup>37</sup> On this basis, the Institute strongly urges the Commission to make an immediate, one-time adjustment to the dollar thresholds that would correct for this erosion.<sup>38</sup> Such a one-time adjustment, coupled with the periodic future adjustments discussed above, would help to ensure that participation in private securities offerings under Regulation D is available only to financially sophisticated investors who are able to bear the economic risk of their investment.<sup>39</sup>

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<sup>37</sup> See Proposing Release at 42 (citation omitted).

<sup>38</sup> The Commission has expressed its reluctance to make an immediate upward adjustment, out of concern that raising the accredited investor standards too high may cause some issuers to conduct private offerings outside the Regulation D safe harbor. See Proposing Release at 42-43. We are not persuaded that this generalized concern should outweigh the very real dangers posed by a failure to maintain high investor qualification standards for most private offerings, which *are* conducted in accordance with Regulation D. As the Proposing Release indicates, issuers have good cause for choosing to comply with Regulation D, including the ability to avoid the "expenses and complications of multi-state securities law compliance and the uncertainty of case law interpretations of the Section 4(2) exemption." Proposing Release at 42.

<sup>39</sup> The Institute recognizes that this recommendation effectively would result in parity between the dollar thresholds in the accredited investor standards, on the one hand, and the proposed standard for "large accredited investors," on the other hand. If the Commission determines to adopt a "large accredited investor" standard, it should do so with higher dollar thresholds, so as to avoid this result.

Ms. Nancy M. Morris

October 9, 2007

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The Institute appreciates the opportunity to comment on the Commission's proposed amendments to Regulation D. If you have any questions about our comments or would like additional information, please contact me at 202/326-5901 or Karrie McMillan, General Counsel of the Institute, at 202/326-5815.

Sincerely,

/s/

Paul Schott Stevens  
President and CEO

cc: The Honorable Christopher Cox  
The Honorable Paul S. Atkins  
The Honorable Annette L. Nazareth  
The Honorable Kathleen L. Casey

John W. White, Director  
Division of Corporation Finance

Andrew J. Donohue, Director  
Elizabeth G. Osterman, Assistant Chief Counsel  
Division of Investment Management

### **About the Investment Company Institute**

ICI members include 8,889 open-end investment companies (mutual funds), 675 closed-end investment companies, 471 exchange-traded funds, and 4 sponsors of unit investment trusts. Mutual fund members of the ICI have total assets of approximately \$11.339 trillion (representing 98 percent of all assets of US mutual funds); these funds serve approximately 93.9 million shareholders in more than 53.8 million households. In addition, the ICI's membership includes 141 associate members, which render investment management services exclusively to non-investment company clients.